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THE 1984 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 21, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2359 Rayburn House Office Building, Hon. Lee H. Hamilton (vice chairman of the committee) presiding.

Present: Representatives Hamilton and Hawkins.

Also present: James K. Galbraith, deputy director; and William R. Buechner, Mary E. Eccles, and Robert R. Davis, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

Representative HAMILTON. The committee meeting will come to order.

I am pleased to welcome two distinguished economists before the Joint Economic Committee this morning to discuss the state of the economy and to evaluate current economic policies. We will hear testimony from Mr. Lawrence Klein, Benjamin Franklin professor of economics at the University of Pennsylvania; and Mr. Robert Eisner, who holds the William R. Kenan chair of economics at Northwestern University.

We hope that today's witnesses will offer some suggestions for policies that will improve our chances for a long period of sustained prosperity.

Gentlemen, we welcome both of you to the committee. We have your statements. Those statements will be entered into the record in full, of course, and we will ask you to summarize them if you can or would so that we can have plenty of time for questions.

Mr. Eisner, will you begin, please.

STATEMENT OF ROBERT EISNER, WILLIAM R. KENAN PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY, EVANSTON, ILL.

Mr. EISNER. Thank you very much, Mr. Vice Chairman. It is a pleasure to be here again. I have a few pieces of previous writings which I have submitted for the record if you are interested, and I will proceed to summarize my statement briefly.

I think it is good to look at where we are and where we might be before we get into what we might do, and I would like to take as a quick framework a reminder of where the Full Employment and Balanced Growth Act of 1978, the Humphrey-Hawkins Act, suggested we should be.

We should have unemployment at 4 percent, inflation at 3 percent, and presumably a high rate of investment.

In fact, unemployment for 1983 averaged 9.5 percent, down at the end of the year but still well above that target. Inflation did much better, down to about 4 percent. Investment, despite all of the great attention given to it by the current administration and drastic changes in the tax law presumably directed at investment, has done quite badly, down from a figure of about $101 billion of net investment in 1978 to $32 billion in 1982 and recovered all the way to $49 billion in 1983.

The unemployment figures, what is more, are predicted in the Economic Report to remain relatively high through the years ahead. The Economic Report suggests 7.8 percent for 1984, 7.6 percent for 1985, and 7.3 percent for 1986. Even in 1989, unemployment would still be at 5.7 percent, well above the target for this year in the Humphrey-Hawkins Act.

On the inflation front, things are doing very well and that should be clearly recognized, but there are, I would say, ominous clouds on the horizon. They relate in good part, in my view, to the rising surge of protectionism which has the effect of raising real costs in the economy and preventing the forces of international competition from taking their appropriate place in holding price rises in check and of forcing prices down in various industries to balance the price increases that might come elsewhere.

There are, of course, serious problems, in a dynamic changing economy, where people get hurt by changes. It is, I think, the proper task of government to protect people against changes without giving us an arteriosclerotic economy in which change cannot take place and prices are artificially kept up.

The other problem on the horizon with regard to inflation does relate to the huge deficits now and into the future. I would like to suggest briefly though, a perhaps slightly offbeat view with regard to deficits, but one which, I think, is important.

I realize that it is a common view and probably good politics to attack deficits on all occasions. In fact, at least in this committee, we should clearly understand that deficits are not always bad, that deficits in a recession tend to help matters, and that it is also important how we measure the deficit and just what kind of deficit we are talking about.

If we look at that picture—and I have in the statement a couple of tables that may make the matter quickly clear—in fact, inflation plays some very curious tricks so that while we have had deficits in the great bulk of years from 1946 to the present and including, as a watershed here I might say 1980, these deficits have not added to the real value of the Government debt and it is that real value of government debt with changes in it which are basically relevant in an economic sense to economic behavior.

In fact, we find that we had repeated deficits but the figures on what happened to the debt, shown in table 1, indicate that debt declined in constant 1972 dollars from $539 billion—the gross public debt—to $496 billion in 1980, and if we take into account the fact that the government itself was acquiring financial assets, and that there were large increases in the value of Treasury gold, we find the net debt actually declined all the more substantially and the net debt per capita actually declined from $3,384 to $1,078, this from 1946 to 1980.

Representative HAMILTON. What is your definition of net debt?

Mr. EISNER. Well, the net debt is the obligations of the Federal Government and the Federal Reserve and associated agencies both in interest-bearing and non-interest-bearing debt, including money, minus the financial assets of the Government, the Federal Reserve, and Government agencies. These financial assets consist in considerable part of Government bonds. They consist of loans that have been made in connection with homeowning, rural electrification and the like, and they also do include gold. That is another matter which we might not leave out. But even if you leave out the gold which has appreciated very much in value, you still have a very substantial decline in real net debt. You indeed have a decline in gross public debt as well.

I would argue that the net debt, perhaps excluding the gold, would be the most relevant measure.

Now if we recognize that a deficit in real terms must be something that adds to the real value of the debt, we adjust the actual deficit for inflation effects. These are essentially the inflation tax on the existing debt. We find then that the high-employment surplus or deficit is rather drastically changed and we get a surprisingly different picture of fiscal policy, at least in the decade of the 1970's.

I think it was a widely held view, and a view of many people, with whom I normally agree, that we had a problem in the 1970's of a fiscal policy which was overly expansionary. We kept running these deficits and even the high-employment budget was going more and more into deficit. The consequence of this was that people felt the inflation must be due in some way to high Government spending and politicians took quite a ride on that. They argued that the thing to do was to cut Government spending to stop the inflation or perhaps to raise taxes. And failing that, you had to have a very tight monetary policy to counteract the inflationary pressure of the easy fiscal policy.

With review or revision of this perception—and I should add that such a review will be appearing in more rigorous form in articles in the American Economic Review in March and in May—we find in fact fiscal policy was really getting tighter and tighter. If you look at my table 2, showing the high-employment surplus adjusted for price and interest effects, you find that after the Vietnam war you run a string through 1982, with just a couple of exceptions, of substantial surpluses.

What was really happening was the Government was running a substantial deficit composed more and more of high nominal interest payments which were not real interest payments. Another way to perceive the adjustment is to correct the deficit or the budget by substituting real interest payments—that is, the actual interest payments minus the rate of inflation times the value of outstanding debt. We would be recognizing then that people or pension funds were getting huge nominal interest payments to compensate them for the loss in the value of their holdings due to inflation. They were therefore not swelling the real income stream out of which people spend.

But then the perception I would like to leave with you is that fiscal policy was tight through 1981 and that, compounded with the tight monetary policy, resulted in the sharp, deep recession of 1981-82, 1982-83, the worst recession that we had had since the Great Depression. And that brings us right up to the present—what to do about it? There was a very sharp profit shift in fiscal policy, effective really in 1982, in that the Economic Recovery Tax Act of 1981, as it was called, did not begin to take much serious effect until 1982, and then the drops in inflation and in interest rates meant that the corrections I was pointing out implied a big switch in the budget. From a high employment surplus adjusted for inflation of 1.97 percent of gross national product in 1981 we moved to a deficit of 1.77 percent in 1982, which is the greatest swing, by some margin, recorded since we started keeping these high employment budget figures, the greatest swing in fiscal policy in 1 year on record.

No wonder, I would suggest—and I have various more or less sophisticated statistical relations to confirm this—no wonder that we had a substantial swing to recovery in 1983. This recovery, I would predict, as I think most people are predicting, is likely to continue pretty much through this year and into the next, in large part because of the substantial budget deficits, at least as long as monetary policy does not turn very restrictive to try to counteract it.

However, that leads me to the following conclusions. Despite all the rhetoric and talk, we would not have been better off to have reduced the budget deficit this year or last year. For the future, we do foresee by all predictions, unless something is changed, a very substantial set of deficits and the adjustment I am talking about does not do any good because inflation is assumed to be less: interest rates are assumed to be coming down. That means we are really assuming a huge deficit even after correction, a deficit which is larger than we can imagine that can be sustained by an economy at full employment—even anywhere close to full employment—by the unfortunate standards being currently applied.

That suggests that we will have substantial inflationary pressure and we will have some set of consequences involving a mixture of inflation and, to the extent the Federal Reserve, as is likely, tries to counteract that by still tighter money, even higher nominal and real interest rates. This will tend to reduce public and private investment and therefore give us a situation where the economy is not growing in a balanced fashion, where long-term growth is jeopardized.

Now I should just close by reminding you that underneath all of these projections in terms of dollars and financial matters of expenditures, there is a real side of the economy, and what we will be having is, on current projections, a very large growth in military expenditures which actually command real resources, which take labor, which take goods and services. As the economy approaches a higher level of employment these resources and goods and services must be taken from somewhere else. They are not going to be taken from slack. And that indicates that the situation will be one in which public and private investment will be starved.

What to do about it? I would think that it is prudent, prompt, to help reduce interest rates, to act now to plan to reduce deficits in the future. But I must say, while I think that is important, what remains of fundamental importance is to see to it that we plan for a really full employment economy. That means going back to the goals of Humphrey-Hawkins which as I suggested were, unfortunately I think, never widely accepted in much of Washington and perhaps in two successive administrations.

There are ways to achieve those goals. They do involve, on the one hand, seeing to it that we have sufficient aggregate effective demand, but also that we take major measures in the way of insuring employment for all—the structurally unemployed, for those who lose their jobs because of the dynamic changes in the economy we do not want to discourage. We should have a program which involves a combination of training, job placement, public employment, and incentives to private employers to see to it that the promise of offering jobs to all who wish to work and the full potential of our economy can be realized.

[The prepared statement of Mr. Eisner, together with attachments, follows:]

PREPARED STATEMENT OF ROBERT EISNER*

It is instructive to compare the national economic goals set forth for the Full Employment and Balanced Growth (Humphrey-Hawkins) Act of 1978 with our current economic situation, prospects and plans. Unemployment was to be 4 percent by 1983. Inflation was to be at 3 percent, and zero by 1988, "provided," as we are reminded in the current Economic Report of the President, "that achieving the inflation goal did not impede achieving the unemployment goal" (p. 202). We are also reminded that Congress, in asking for an Investment Policy Report, found that "high rates of capital formation are necessary to ensure adequate rates of capacity expansion and productivity growth, compliance with governmental health, safety and environmental standards, and the replacement of obsolete production equipment" (p. 201).

Unemployment for 1983 in fact averaged not 4 percent but 9.5 percent, while declining from 10.6 percent in December 1982 to 8.1 percent in December of 1983. Inflation did somewhat better, declining to a rate of just over 4 percent for 1983, as measured by the GNP implicit price deflator. Gross private domestic investment in constant 1972 dollars remained well below its peaks of 1978 and 1979 despite Administration-advanced tax policies designed to encourage investment. In fact, by the measure of net private domestic investment (with which I have some reservations), we see a decline from $100.9 billion in 1978 to $32.0 billion in 1982 and a "recovery" to $49.3 billion in 1983.

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*William R. Kenan Professor of Economics, Northwestern University

The unemployment figures, past, current and projected, are particularly dismaying. It is no secret that many in high administrative capacities in Washington have rejected the full employment goals of the Humphrey-Hawkins Act. In 1980, a conscious policy was instituted to create slack in the economy in order to combat inflation despite the clear implication that this would raise unemployment. This policy was brought to fruition with a vengeance by the current Administration in the 1981-82 recession which saw unemployment at its highest levels since we came out of the depression of the 1930's.

Compounding the matter, however, are the Administration economic assumptions for 1984-89, considered rosy in some quarters, which see unemployment averaging 7.8 percent this year, 7.6 percent next year and 7.3 percent in 1986. Indeed, even by the end of the forecast period, 1989, the unemployment rate, at 5.7 percent, is still to be well over the Humphrey-Hawkins target of 4 percent for 1983.

It seems reasonably clear that there is no real commitment to achieving the Humphrey-Hawkins goals. Aggregate demand is frequently insufficient to eliminate the unemployment chronically associated with inadequate real purchasing power. And little has been done and even less envisaged to reduce the structural unemployment and lacks of opportunity for major segments of the population, in particular, blacks and youth. True dedication to achieving full employment goals would encompass meaningful programs of education and training, public employment and incentives for private employment.

On the inflation front, we have been relatively fortunate, but ominous clouds are on the horizon. We have been fortunate because the impact on price movements of the recession has been combined with a major shift in the supply factors which were the dominant factor in the inflation to begin with. In particular, the turnabout in world oil prices reversed the overwhelming impetus to inflation of the last decade.

The ominous clouds relate to the major moves toward protectionism and government intervention to maintain and raise prices at the behest of apparently politically powerful minorities in the population. "Voluntary" agreements to hold down imports of Japanese automobiles have provided a bonanza to Japanese manufacturers as well as U.S. car producers who have been able to raise prices as a consequence of reduced foreign supply. Agricultural programs are increasingly directed to meeting problems of farm income by restricting supply and raising prices. And throughout, the Administration, often under real or imagined pressure from the Congress, has been contributing to trade restrictions which will add to inflation and lower the real productivity of the Nation.

In addition to these major interferences with the competitive forces which might be expected to hold inflation in check, projected fiscal policy evidenced in the large anticipated future deficits threatens a period of excess demand such as we have really not experienced since the years of peak involvement in the war in Viet Nam.

The capital accumulation picture is a singularly perverse one. Probably the most significant capital formation as regards long term growth is that in social overhead capital and human capital and knowledge in particular. These are areas largely within the purview of government and recent policy has tended to starve them. Under the guise of cutting domestic spending and the rationale that "throwing money at problems" does not solve them, this vastly important form of investment has been curtailed.

Ironically though, private domestic investment, including in particular business plant and equipment spending, much to be favored in principle by the current Administration, has also declined precipitously. The so called Economic Recovery Tax Act of 1981 was heavily weighted in favor of business investment and private saving. It was argued that this Act would result in substantial increases in presumably lagging business investment. In fact, as we have noted, business investment fell sharply and residential housing investment suffered catastrophic declines.

Some of us had predicted this, arguing that the presumed incentives embodied in the tax act, particularly the vast increases in tax depreciation in the "accelerated cost recovery system" and the extension of the investment tax credit, would have relatively little impact in increasing business investment. Indeed whatever favorable impact they may have had was much more than offset by the impact of the recession and of higher real interest rates.

The current mix of monetary and fiscal policy is uncertain and probably unstable. Much discussion of the issue, however, has unfortunately been drowned in political rhetoric, on one side or the other. Failure to perceive correctly our recent past has inhibited in varying degrees our ability to understand the current situation and to program the future.

As I have argued on numerous occasions, budget deficits are not necessarily an unmitigated evil. Most important, they must be measured correctly, with due distinction among cyclical and structural deficits and appropriate adjustment of conventional accounting procedures to capture the real economic factors at work.

It has been widely argued that increasing deficits, even increasing "high-employment" or cyclically-adjusted deficits, indicated over-expansionary policies in the decade of the 1970s. In truth, appropriate adjustment for inflation in the high-employment budgets suggests that fiscal policy through 1981 was indeed not expansionary but increasingly contractionary. In the main, misconceptions stemmed from failure to recognize the "inflation tax" inherent in the decreasing real value of existing government debt. Significant high-employment deficits may frequently be viewed correctly as expansionary or even inflationary if they represent real increases in the value of existing public debt held by the private sector. In periods of inflation, however, and, _a fortiori_, periods of rising interest rates, large deficits may coexist with declines in the real value of outstanding debt. Simply enough, the market value of existing debt falls as interest rates rise and the real value falls further as the general price level increases.

Thus, we have had a vast decline in the real net public debt in the years from 1946 to 1980, from $470.1 billion to $238.6 billion despite the current nominal deficits. Over that period the real net debt per capita declined from $3,384 to $1,078, as seen in Table 1.[1]

Another way of looking at this is to recognize that in periods of substantial inflation the Treasury makes very considerable nominal interest payments, currently over $100 billion per year, which in large part constitute repayment of capital, or compensation of bondholders for the declines in the real value of their holdings due to inflation. If we were to substitute among budget expenditures real interest payments for nominal interest payments, we would find expenditures vastly reduced and the deficit cut correspondingly

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[1] Reproduced from Table 4 of Robert Eisner and Paul J. Pieper, "A New View of the Federal Debt and Budget Deficits," _American Economic Review_, March 1984, _74_ (1).

What happened then in the years leading up to 1981 was that a tight money policy calculated to counteract an allegedly expansionary fiscal policy actually served to complement a tight fiscal policy as measured by an inflation-adjusted, high-employment budget surplus. It is no wonder that the combination of tight monetary policy and tight fiscal policy proved almost lethal and brought the economy to the depths of the recent recession.

In 1982, fiscal policy turned very sharply from restraint to expansion. The inflation- or price-and-interest-adjusted high-employment budget moved from a surplus of 1.97 percent of GNP in 1981 to a deficit of 1.77 percent of GNP in 1982, the greatest such shift in a single year on record.[2] This large inflation-adjusted deficit continued through 1982 and very largely through 1983. It is hence no wonder that the economy recovered sharply in 1983 and that that recovery is apparently still continuing.

This is not to say that the recovery is as yet adequate. As may be recognized from the unemployment figures discussed above as well as from any comparisons of real gross national product with potential gross national product as may be calculated from a potential or high-employment growth path over recent years, our recovery still has a significant way to go.

In that context, it is clear that we should be careful not to move too soon to reverse the stimulus that has finally propelled the economy forward. This means that we must preserve and extend what relaxation of our monetary posture has developed and we must be slow to tighten our fiscal stance with action to reduce the structural budget deficit. Given the rates of unemployment and excess capacity and the slowness in recovery in investment, moves hardly seem in order to tighten the fiscal or monetary screws now.

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[2] As shown in Table 2, taken from Tables 6 and 10 of Eisner and Pieper (1984).

The future is another matter. Projections of budget deficits, cyclically-adjusted and inflation-adjusted, are very high through the 1980's. They do indeed imply rates of aggregate demand which will prove excessive. I must confess that if we are to choose between erring in the way of insufficient aggregate demand or excessive aggregate demand I would prefer the latter. For insufficient aggregate demand means recession, unemployment and great losses in real output. Excess demand, curious as it may seem to put it this way, implies in itself only inflation. And moderate inflation, it must be insisted, unpleasant and unpopular as it may appear, need be no more than a nuisance, rather than a real loss, as long as real output, employment and the allocation of resources are not seriously adversely affected.

Nevertheless, it is better to have clearly adequate aggregate demand than excess demand. Prospective continuing budget deficits when we are well out of the recent recession and even after correction or adjustment for assumed inflation do appear excessive. The consequence is likely to be an increase in development of inflationary pressures which will be met by tighter monetary policy. The result will be a mixture of a new increase in inflation and high nominal and real interest rates. These in turn will discourage public and private investment.

The arithmetic of correcting this is fairly simple. With domestic federal spending already sharply curbed, the burden of the deficit is fairly laid to large increases in military spending coupled with large cuts in tax rates. The remedy, clearly enough, is to reduce the planned growth in military spending and/or raise taxes.

While such adjustments to the budget during the current year will be likely in themselves to curb economic recovery, action now to indicate that the deficits will be curbed in the future may well be helpful. For anticipation of future budget deficits and their consequences would appear to be a significant factor in keeping up current interest rates, both nominal and real, and thus discouraging investment. The high interest rates also increase foreign demand for dollar investments and thus raise the value of the dollar with sharply unfavorable effects on net exports. Action now to lower projected future deficits would lower real interest rates now and in the future, thus supporting current expansion and opening the way to extended, balanced growth.

While the overall directions of curbing government expenditures in the aggregate and raising taxes in the aggregate are clearly indicated to reduce budget deficits and hence eliminate excess demand, it is important to distinguish among kinds of government expenditures and taxes.

Thus, as I have argued elsewhere,[3] certain kinds of government expenditures may prove inflationary because they are directed at resources in short supply. This is likely to prove significantly true where the government undertakes rapid increases in expenditures for particular categories of goods as in a rapid acceleration of military spending. Cuts in the rate of that acceleration if not actual reductions would then prove especially anti-inflationary.

Some government expenditures for goods and services may in fact prove deflationary. Improvement of the federal highway system may be expected to lower transportation costs, thus affecting real savings as well as lower prices. Expenditures for food stamps will clearly lower the cost of food to those who use them. Reduction of the food stamp program would, hence, be directly inflationary to those affected. Similarly, government subsidies for the postal service, mass transit, and low rent housing will hold down prices. Reductions in such government expenditures will add to inflation both directly and as the immediately higher prices feed back through the economy.

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[3] "Inflation, Unemployment and the Federal Budget," in The Conference Board, Toward a Reconstruction of Federal Budgeting (New York, 1983), pp. 59-64.

As with government expenditures, we must distinguish among taxes. Despite much publicized claims of "supply-side economists" to the contrary, changes in personal tax rates, at least in the magnitudes that have been involved, are likely to have much greater effects upon demand than upon supply. But there are taxes that more greatly if not entirely affect supply. Payroll taxes on employment, now some 14 percent for social security and several percent more on lower incomes for unemployment insurance, cannot but adversely affect the supply of labor. Excise and sales taxes directly reduce supply of taxed commodities, thus contributing to both higher prices and lower output. Increases in telephone and air-travel taxes, enacted presumably to reduce budget deficits considered to be inflationary, also contribute to higher prices and hence, by reducing real purchasing power, tend to constrain recovery in output and employment.

In broad summary, our policy aimed at sustained expansion and achieving our statutory goals of full employment and price stability must begin by insuring adequate but not excessive rates of aggregate demand. These should be accomplished by a balanced program of appropriate fiscal and monetary expansion to lay a basis for realizing our economy's full potential. Projected future deficits should be reduced to levels consistent with non-inflationary growth in real demand and output. Monetary policy should be directed then not at constraining the economy, with consequent high real interest rates, distortions in credit markets and curbing of capital accumulation, but rather to provision of the liquidity necessary for balanced growth. The deficit, it may be added, may well be maintained over the long run not at a zero level but rather at a level sufficient to increase the net government debt at the same percentage rate as gross national product or national income. For the 1983 fiscal year this would have implied a deficit of $100 billion, or 3.24 percent of GNP, but not the actual $186 billion, or 6 percent of GNP, related considerably to the recession.

Realization of price stability goals can be facilitated most by eliminating government interventions at the behest of varied particular groups which all add up to restriction of output and elevation of prices. Agricultural policies should be altered to enhance supply, with appropriate attention to income maintenance for truly needy farmers in ways that do not reduce output and raise prices. International trade should be freed and fostered on the basis of a value of the dollar in foreign exchanges which is relieved of the excesses brought on by current and prospective high interest rates.

It is important that the statutory goals of full employment be followed assiduously and that all necessary measures be instituted to realize them. These are likely to encompass full government responsibility for employment, including education, training and placement for the young leaving school, women and veterans seeking and reseeking employment and those of all ages who lose the opportunity to work because of technological and other change in a dynamic economy. Policies to this end are likely to include both public employment and really adequate subsidies or incentives to private training and employment.

Finally, we must recognize the true role of government in diverting or freeing and devoting resources to capital accumulation and growth. Whatever the measure of benefits from vastly accelerated military expenditures, it must clearly be recognized that in a full-employment economy, such expenditures necessarily divert resources from either private consumption or private and public investment or both. While few quarrel with the costs of adequate defense of our future, huge increases in military spending, aside from their possibly destabilizing impact on international relations and world security, may well undermine the economic foundations of the future we are endeavoring to protect. For that future depends on both free private economic activity and private capital formation and on the development of public capital in the form of ability, knowledge and training of a healthy, work-oriented nation.

Table 1. The Real Value of Federal Debt

(1) Year	(2) Gross public debt	(3) Net debt	(4) Budget surplus (+) or deficit (-)	(5) Net revaluation of net debt	(6) Change in net debt	(7) Net debt per capita	(8) Change in net debt per capita
	Billions of 1972 dollars					1972 dollars	
1946	539.2	470.1	8.0	-83.6	-	3,384	-
1950	459.1	350.8	17.2	-31.8	44.0	2,326	-338
1960	421.4	299.1	4.4	8.7	5.8	1,679	6
1970	415.3	269.9	-15.3	1.7	15.4	1,338	60
1975	445.9	278.9	-55.2	-2.2	57.3	1,320	259
1976	481.3	318.2	-40.2	-4.2	39.3	1,482	162
1977	498.6	320.5	-33.2	-37.9	2.3	1,482	-0
1978	503.4	296.7	-19.5	-51.1	-23.8	1,364	-118
1979	496.6	244.8	-9.1	-71.4	-51.9	1,120	-244
1980	495.9	238.6	-34.5	-42.9	-6.2	1,078	-42

Table 2. High-Employment Budget Surplus or Deficit as Percent of GNP Official and Adjusted

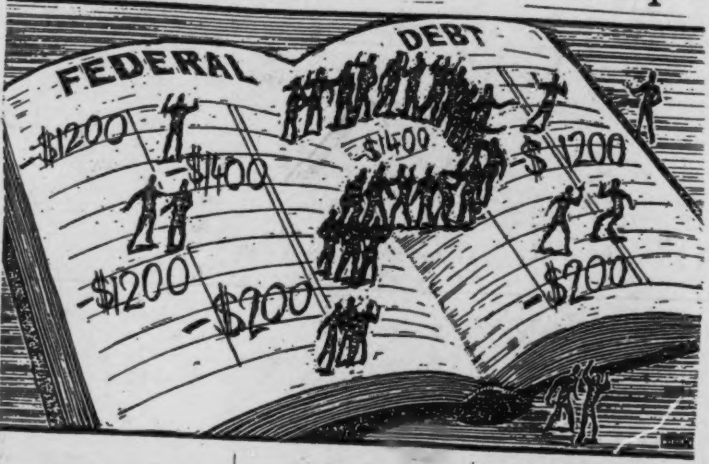
(1)	(2)	(3)	(4)
	High-Employment Surplus (+) or Deficit (-)		
Year	Official	Adjusted for price effects	Adjusted for price and interest effects
1955	1.30	2.81	3.71
1956	1.87	3.83	4.63
1957	1.37	2.47	1.26
1958	0	.93	2.21
1959	1.11	2.09	2.90
1960	2.39	2.84	.98
1961	1.35	1.99	2.44
1962	.53	1.29	.91
1963	1.24	1.79	2.26
1964	.17	.78	.73
1965	.13	.98	1.42
1966	-.74	.34	.09
1967	-1.89	-.89	-.38
1968	-1.26	.06	.20
1969	.52	1.95	2.68
1970	-.46	.77	-.64
1971	-1.05	.12	-.21
1972	-1.02	.02	.42
1973	-.72	.89	1.13
1974	-.02	2.16	1.97
1975	-1.88	-.37	-.55
1976	-1.01	.22	-.52
1977	-1.13	.39	1.27
1978	-.70	1.30	2.16
1979	-.09	1.74	1.81
1980	-.81	1.31	1.63
1981	+.15	1.92	1.97
1982	-1.08	.01	-1.77
1983	-1.75	-.48	-1.46

Forum

THE NEW YORK TIMES, SUNDAY, SEPTEMBER 25, 1983

ANOTHER INFLATIONARY ILLUSION

Will the Real Deficit Please Stand Up?



By ROBERT EISNER

INFLATION plays all kinds of tricks, and not the least of them on Federal budgets. The tricks have greatly confused public discussion of budget deficits, past, present and future.

In ordinary accounting one may think of a budget deficit as adding to outstanding debt. Thus, if at the end of 1982 the Federal Government were to have a debt of $1,200 billion, a 1983 deficit of $200 billion should be expected to raise the debt to $1,400 billion at the end of 1983.

Economists see such an increase in debt, other things being equal — and contrary to many public views — as essentially stimulatory. The presumed reason is that, paradoxically, the debt of the Government is an asset to private individuals. The greater the Government debt, the more we all own in Government bonds and, other things being equal, the wealthier we are likely to feel. Hence, the more we will be ready to spend.

Of course, when deficits occur and the debt goes up, other things are not generally equal. If a deficit stems essentially from recession-induced decreases in tax revenues and increases in expenditures for unemployment benefits, the stimulus of the deficit is only a minor, although not unimportant, counterbalance to the slump itself.

But, first of all, Government deficits need not add up to net increases in private assets. In a forthcoming paper in the American Economic Review, Paul J. Pieper of the University of Illinois-Chicago and I note that while the Federal Government reported deficits totaling no less than $336 billion from 1947 to 1980, the market value of net Federal debt over that period grew by only $222 billion.

This relates in part to the fact that Federal deficits are considerably financed by increased holdings of debt by the Federal Reserve and various Government-related agencies and trust funds, rather than by the public.

And secondly, the market value of private holdings of Federal debt is affected by prevailing interest rates. As inflation and tight monetary policy, until recently, drove interest rates sky-high, bond prices fell, and with them the market value of Federal debt. Yet that is only a small part of the story. Inflation further reduces the real value of outstanding Government debt.

THUS, over that same post-World War II period, while budget deficits totaled $336 billion, the real market value of the debt, in 1972 dollars, went *down* by $231 billion. Perhaps astonishingly to some, with all these years of deficits from 1946 on, the real net debt per capita fell by some two-thirds, from $3,384 in 1972 dollars at the end of 1946 to $1,078 by the end of 1980.

All this gives us a sharply different perspective on recent and current budget deficits. Budget deficits, remember, are considered stimulatory because private holdings of the new debt put out to finance the deficits give the public a feeling of greater wealth, which brings on more private spending.

But if inflation and higher interest rates leave the public *poorer* in its real holdings of Government debt, we can hardly view the deficits as stimulatory at all, let alone overstimulatory.

To make our measures of Government deficits more meaningful in a period of inflation, we must adjust for the "inflation tax" that the Government collects from the public in the form of depreciation in the real value of Government liabilities — what the Government "owes" us is worth less. As shown in figures that I prepared with Professor Pieper for the 1982 Economic Report of the President, such a "revaluation" of net Government debt turned a 1980 deficit of $61 billion — in the National Income Accounts — to a surplus of $7 billion.

It has been widely perceived that tight monetary policy contributed significantly to our severe recession. Tight money has been supported by many and tolerated by others in the view that it was necessary to correct what they perceived as an overstimulative fiscal policy. But Federal budget policy, as evaluated with appropriate corrections for inflation, was in fact not stimulatory but restrictive from 1977 to the middle of 1982.

It was hence very likely a near-lethal combination of tight monetary and fiscal policies that contributed to the recession and brought the unemployment count to 12 million.

Large projected Federal deficits some years from now, with inflation down, are quite another matter. The lower "inflation tax" means that the properly adjusted budget turned particularly stimulatory in 1982, and the emerging recovery is hardly unrelated to this stimulus. Huge deficits in post-recovery years, however, could well put the economy through a new inflation wringer.

Understanding the real measure and impact of budget deficits will help us see how we got into economic decline. It should also help clarify the policies to get us out of it and avoid new problems in the future. ■

Robert Eisner is William R. Kenan Professor of Economics at Northwestern University.

DEAR DR. EISNER: THANKS VERY MUCH FOR YOUR FIRST CONTRIBUTION. WE WERE QUITE PLEASED. I'LL SEND YOU CLIPS AS WE COLLECT THEM.
BEST REGARDS, BERL SCHWARTZ, FEATURE-WIRE EDITOR

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TWO TAKES
RELEASE DATE:1-13-84

(Robert Eisner is professor of economics at Northwestern University, a former Guggenheim Fellow, a member of the American Academy of Arts and Sciences and author of numerous books and articles.)

VIEWPOINT ON THE ECONOMY
By ROBERT EISNER
Scripps-Howard News Service

A budget deficit is like sin.

To most of the public it is morally wrong, and it seems difficult to avoid.

Further, every dollar of deficit is presumed to add a dollar to debt. And debt is bad!

With the Reagan administration we have had the biggest budget deficit in history, $195 billion in fiscal 1983. The gross public debt in three short years has gone from $930 billion to over $1,400 billion.

But are deficits and debt necessarily bad? Is reducing or eliminating them good? The answers must be, ``It depends.''

It depends on the amount of the deficit and the debt. It depends upon where the government is borrowing, at home or abroad, and who holds the resultant debt. It depends upon how we measure. It depends on what the deficits are financing. Most of all, it depends upon the state of the economy.

In magnitude, the current debt is almost 6 percent of gross national product -- a relatively high level for peacetime. The ratio of debt to GNP increased from 35 to 42 percent since the end of 1980. Still, it remains far below earlier highs such as the 130 percent after World War II.

More than 85 percent of the debt is domestically held. About $400 billion -- or 28 percent of the total -- is held by the Federal Reserve banks and U.S. government agencies and trust funds themselves.

In terms of measurement, we make no allowance for inflation. As recently as 1980, the measured deficit was less than the amount of existing debt being wiped out each year by inflation. This ``inflation tax,'' through 1981, turned supposedly stimulative nominal deficits into repressive surpluses in economic reality. Though not widely understood, tight fiscal policy, as well as tight money, contributed to the deep recession of 1981-82.

With the deficit up and inflation down, however, fiscal thrust has changed dramatically. The real deficits with full adjustment for inflation are high. And the real value of the debt is projected to increase during the rest of this decade.

Familiar analogies between public and private debt are frequently treacherous, but there are some similarities. A private deficit or borrowing to go on a drunk or bet on the races may be bad. Going into debt to finance one's education or buy a house or build a new plant is very possibly good.

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Federal investment-type outlays have been estimated by the Office of Management and Budget at $122 billion in fiscal 1983. A public deficit to finance investment in roads, bridges, airports, R&D, health and education may also be good.

And, deficits or borrowing, public or private, that are small compared to current and anticipated future income can hardly cause much harm.

But there are also different criteria for the federal government. It is not a person whose well-being is significant in itself. Rather, its budget and its policies must be judged in terms of their effect upon the people to whom it is responsible.

Looked at that way, running a deficit and increasing the debt can be helpful to the economy. Its alternative can clearly be worse.

Thus, a significant part of the huge federal deficit of the past two years can be attributed to the recession from which, with unemployment down but still at 8.2 percent, we are hardly fully recovered. Had we been at ``high employment'' -- 5 percent unemployed -- the fiscal 1983 deficit would have been not $195 billion but only $58 billion. To have reduced the actual recent deficits, either by raising taxes or cutting government expenditures, would have deepened or prolonged the recession.

Raising taxes during a recession, or too early in a recovery, reduces the still-depressed ability of households and business to spend, thus leading to lower sales, production and employment. Desirable as they seem to many, reductions in federal spending have essentially the same effect. If the public receives less in the way of Social Security benefits or other government payments it again must reduce its spending. If the government itself spends less for goods and services, business sales and production and labor income are reduced directly.

The large deficits in the past two years, not from the supply side but by first sustaining and then stimulating demand, deserve a major share of credit for economic recovery. But when the economy is fully out of recession, relatively large deficits are another matter. They can then create excess demand or purchasing power that will be inflationary. The consequent danger lies in distorting the economy and, in the efforts to combat the inflation, creating a new recession.

Reports that the administration will seek a further 17 percent increase in already swollen military spending in fiscal 1985 underscore the problem for the future. Enormous deficits are looming for the years ahead, when the recession is supposed to be old history.

Building on Congressional Budget Office data, on the basis of current tax and expenditure projections I estimate the calendar 1988 *high-employment* deficit, for example, at some $202 billion. Such deficits would surely rekindle inflation. If the Fed tries to combat the inflation with tight money, as has become customary, real interest rates, already high, must rise.

We would thus have a garrison state economy at the expense of private investment -- in housing and in business plant and equipment -- as well as the loss of public capital and social services that some lament.

SHNS

Toward a Reconstruction of Federal Budgeting:

A Public Policy Research Program Conducted by The Conference Board (Full Proceedings)

A Research Report from The Conference Board

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Inflation, Unemployment and the Federal Budget

Robert Eisner

Some Myths, Propositions and Perspective

(1) Federal budget deficits are not the general cause of inflation. In the last year we have seen the rate of inflation decline sharply while the federal deficit has soared.

(2) Government spending is no more a general cause of inflation than is private spending. Sharp increases in spending of any kind can, under certain circumstances, be inflationary. Some government spending can be deflationary.

(3) Higher tax rates to balance the budget may or may not prove deflationary. Increases in current tax rates during a recession are likely to aggravate the recession and increase unemployment. Increases in some kinds of taxes can create more unemployment *and* increase inflation.

(4) There is no simple one-to-one relation between inflation and unemployment. Budgetary actions that increase inflation may not reduce unemployment. Inflation itself, however, does not cause unemployment. Certain government policies to combat inflation do cause unemployment.

The propositions stated so baldly above may best be understood and evaluated in terms of those oldest of economic concepts—demand and supply. Budgetary policies that increase the total or aggregate demand for goods and services will increase output (and employment) and/or prices. Government policies that decrease the aggregate demand of goods and services will reduce output (and employment) and/or prices.

Government policies that increase the aggregate supply of goods and services to the market will increase output (and employment) and/or reduce prices. Government policies that reduce aggregate supply will reduce output (and employment) and/or raise prices.

The Varied Impact of Government Expenditures

There is no correct, simplistic conclusion to be drawn as to the impact of government expenditures on aggregate demand, inflation and unemployment. It depends critically on what those expenditures are, how they are conditioned, and how they change. Increases in government expenditures for goods and services will generally have a direct impact upon output. If, as is currently the case, there is considerable slack in the economy, increased government spending for goods and services will generally bring about more output, less unemployment, and little or no upward pressure on prices. Particular kinds of government spending can be inflationary by directly bringing about price increases. An obvious case in point would be purchases of agricultural commodities or other materials for the express purpose of raising or holding up prices. Such action may have substantial [illegible]le effects as these higher prices are passed on through the process of production, and as wage earners and others obtain cost-of-living adjustments in turn.

Certain kinds of government expenditures may prove inflationary because they are directed at resources in short supply. This is likely to prove particularly true where the government undertakes rapid increases in expenditures for particular categories of goods, as in a rapid acceleration of military spending.

Some government expenditures for goods and services may prove deflationary. Improvement of the federal highway system may be expected to lower transportation costs, thus effecting real savings as well as lower prices. Expenditures for food stamps will clearly lower the cost of food to those who use them. Reduction in the food-stamp program will, hence, be directly inflationary to those affected. Similarly, government subsidies for the postal service, mass transit, and low-rent housing will hold down prices. Reductions in such government expenditures will add to inflation both directly and as the immediately higher prices feed back through the economy.

Purchases of goods and services constitute only one-third of Federal Government expenditures. Fully 42.5 percent are made up of transfer payments. These generally contribute to aggregate demand and, hence, to output and employment. How much they do so, however, depends upon the spending propensities of recipients. Increases or decreases in transfer payments are likely to have a less certain and probably more delayed effect than similar changes in expenditures for goods and services. Changes in transfer payments financed by equivalent changes in taxes will generally affect aggregate demand and production only to the extent that the marginal propensities to spend of taxpayers are different from those of the people receiving the transfers. There is, therefore, no prima facie reason to believe that the great recent increases in transfer payments, in social security and federal retirement benefits in particular, have been inflationary. Similarly, there is no reason to believe that general cuts in such social benefits, along with corresponding reductions in taxes, will be anti-inflationary.

Grants-in-aid to state and local governments constitute over 11 percent of federal expenditures and are also not readily classifiable as inflationary. Reduction in grants-in-aid may frequently prove both inflationary and productive of increased unemployment. They force state and local governments into some combination of layoff of employees and reduction of public services on the one hand, and increased sales or property taxes—which directly or indirectly raise prices of final products—on the other.

Net interest paid, also currently over 11 percent of federal expenditures, is essentially akin to transfer payments in its effect upon aggregate demand and purchasing power. To the extent, however, that high interest payments reflect high interest rates, they may also unfortunately tend to be productive of both more inflation and less employment. For the high interest rates will discourage business and residential investment as well as purchase of consumer durables, thus reducing output and employment, while constituting a higher cost of production, thus bringing on higher prices. The latter direct, upward effect on prices may substantially counterbalance—or even outweigh—the indirect, downward effect of lesser output and greater unemployment.

Finally, the relatively small item of subsidies less current surplus of government enterprises, about 1.6 percent of Federal Government expenditures, tends to be both deflationary and productive of employment. The greater the government subsidies and the less the current surplus of government enterprises, the less will be the prices of the products affected. And the less these prices are, the greater will be demand and output and, hence, employment.

None of these considerations should be allowed to obscure the fundamental difference between effects of federal expenditures and changes in federal expenditures under conditions of full or high employment and under conditions of substantial unemployment. All too much public and political discussion ignores this difference. Under conditions of relatively full employment, increases in aggregate demand brought on by direct government purchases of goods and services, or by transfer payments or interest payments to individuals or business, will contribute to inflation. For, as such increases in expenditures swell aggregate demand, there will be little or no increase in supply available to meet that demand. Hence prices will rise and may set off an inflationary spiral that will be continued and reinforced if government continues to increase expenditures at a faster rate than can be accommodated by increases in supply.

These inflationary pressures may be only partly abated by higher taxes to finance the expenditures. Higher taxes to finance transfer payments or interest payments may well bring fully offsetting reductions of their effects in inflating demand. But since the depressing effect on demand of taxes is only indirect or secondary, they may well prove an uncertain and inadequate counterbalance to rapid increases in federal expenditures for goods and services. This observation proves of particular relevance to rapid military buildups. The failure to raise taxes promptly to pay for our military escalation in Vietnam has frequently been viewed as a significant contributor to the inflation of that era. It may be aptly observed, however, that even a pari passu increase in taxes might well have proved insufficient to stem inflation at that time.

The effects of government expenditures on output, employment and prices under conditions of general unemployment and excess capacity are vastly different. Under these circumstances, increases in aggregate demand that will be generated by increases in federal expenditures can be expected to increase output and employment and have minimal effects, if any, in raising prices. Here again, though, changes in federal expenditures for goods and services will have a more immediate and direct impact than changes in transfers or interest payments. Rapid increases in federal expenditures for particular kinds of goods and services that may be in short supply, such as those involved in rapid military buildups, may still cause inflationary movements in those areas but their spillover effects in the general economy are likely to be damped.

It must be observed, therefore, that moves to cut federal expenditures in a time of recession, whatever the general political popularity of such moves, can only be expected to aggravate the recession by reducing aggregate demand and purchasing power. To the extent that reductions in federal expenditures are in purchases of goods and services, corresponding cuts in taxes are not likely to be fully offsetting in their effects upon demand, production and employment. In this connection, it may be noted that federal expenditures for goods and services in the current recession moved down as the economy worsened, rather than in countercyclical fashion. Decreases in nondefense federal expenditures considerably exceeded increases in expenditures for national defense. Thus, from the fourth quarter of 1981 to the second quarter of 1982, total federal expenditures for goods and services declined 2.5 percent in current dollars, from $250.5 billion to $244.3 billion. The relative decline in constant dollars was 4.9 percent.

Cuts in federal expenditures to reduce demand would be indicated in order to counteract an inflation induced by excess aggregate demand. Excess aggregate demand is to be associated with high employment and an overall spending propensity that is greater than the value of output that can be produced at current prices. Since such a situation is usually, if not always, brought on by great increases in government spending to begin with, reductions in government spending are all the more the indicated remedy.

An inflation brought on by supply shocks, such as our recent bouts with tremendous oil price increases, as well as those of agricultural and other raw materials in world markets, is quite another matter. This kind of inflation may well be associated with a generally depressed state of the economy. The twin conditions of stagnation and inflation have, indeed, brought forth a descriptive term, "stagflation." In the face of major price increases in some areas, the inadvertent or purposeful failure of government to provide accommodative fiscal or monetary policies results in a sharp reduction in real effective demand. Under conditions of perfect competition in all markets, one might look for downward adjustments in prices not directly affected by the supply shock so that real demand would be maintained. It is clear that this does not occur in the real world, and cannot reasonably be expected to occur. Thus the combination of inflation and recession that hit so hard and, to some, paradoxically in 1974-1975.

The answer to such an inflation is not a contraction of federal budget expenditures. This is likely to have little immediate effect on either the offending prices in the initial supply shock or on the general level of other prices. Its immediate effect may be expected in output and employment, both of which will be all the more reduced by a contractionary federal budget policy.

Indeed, unless the supply shocks are repeated, the initial inflationary spiral will subside. Contractionary federal budget policies (or contractionary monetary policies) will have a further effect in reducing inflation to the extent that they create a sufficient sharp and lasting recession. The substantial reduction in inflation in the United States economy over the past year must be attributed in part to the leveling off and decline in petroleum and agricultural prices—the ebbing of the supply shock—and in part to cuts in federal expenditures as well as repressive monetary policies. Many will consider the cost in lost output and employment, which has been imposed in order to achieve the marginal further reduction in inflation, excessive.

The Effect of Taxes

Many of the implications of changing tax rates may be inferred from our discussion of federal expenditures. Increases in income taxes, like cuts in transfer payments, will reduce disposable income and, thus, indirectly reduce aggregate demand. They are an appropriate remedy for an inflation due to excess demand. As a remedy to a supply-shock or cost-push inflation, they are likely to do more in the way of bringing on recession and lost output and employment than lower prices, unless they are pursued to extremes in magnitude and duration.

But as with government expenditures, we must distinguish among taxes. Despite much publicized claims of so-called "supply-side economists" to the contrary, changes in personal income tax rates, at least in the magnitudes that have been involved, are likely to have much greater effects upon demand than upon supply. I am fond of asking business executives whether reductions in personal income tax rates by 25 percent, say from 50 percent to 37.5 percent, are likely to make them work harder. I have yet to find any with the temerity to answer in the affirmative; perhaps none wishes to assert that he or she is not already working as hard as possible. (For low-income groups, the Economic Recovery Tax Act of 1981 and changes in various programs of transfer payments do not alleviate, and in a number of areas aggravate, the serious problem of marginal effective tax rates, or loss-of-benefit rates, approaching—and in some cases in excess of—100 percent. It is in this area that the high marginal bite on current income may well be having seriously deleterious effects upon labor supply.)

But there are taxes that more greatly, if not entirely, affect supply. Payroll taxes on employment, now approaching almost 14 percent for social security and several percent more on lower incomes for unemployment insurance, cannot but adversely affect the supply of labor. Excise and sales taxes directly reduce the supply of taxed commodities, thus contributing both to higher prices and lower output. Recently enacted increases in telephone and air-travel taxes, to reduce budget deficits considered by some to be inflationary, will thus in some measure contribute to higher prices while aggravating the recession and unemployment.

Reductions in effective tax rates on capital income and saving may, other things being equal, increase saving and capital formation. Other things are generally not equal, however, and, in particular, the higher real-interest rates that accompany the business tax reductions 1981 have probably themselves more than offset the presumed tax stimuli to investment. Add income effects may so outweigh substitution effects that lower taxes on saving may leave people with less need to provide for the future and, hence, may reduce aggregate saving.

While cuts in income taxes will themselves increase private saving, unless they result in sufficient increases in output and income they must reduce the total of private and public saving. With output and income unchanged, for example, each dollar reduction in taxes will reduce public saving (or increase public dis-saving, the budget deficit) by a full dollar. Even if beneficiaries of the tax cut save, say, 40 cents of each of their extra dollars of disposable income, there will be a *reduction* in total saving, and hence in gross investment, of 60 cents for each dollar reduction in taxes. Ironically, beneficial effects of personal income-tax cuts on aggregate gross saving would stem not from the propensities of those with lower taxes to save but from their propensities to spend. For increases in private spending would induce greater output and income, out of which there could be more private saving as well as increases in tax revenues to offset reductions in public saving, and also induce increases in investment demand for inventories and fixed capital to be used for increased production.

The effects of increases in investment demand, however, are mixed. Like any other increases in demand for goods and services, public or private, under conditions of substantial unemployment and excess capacity they are likely to increase output and employment but generate little or no inflation. As full capacity is reached, increases in investment demand, like other increases in demand, will tend to cause increases in prices that may initiate or accelerate inflation. It is frequently argued that more capital accumulation will increase productivity and, therefore, reduce costs and prices. This is at best, though, a long-run effect, and it depends both on the capital investment actually being productive—and not merely the consequence of tax advantages—and also on any gains from productivity being realized in the form of lower prices rather than higher wages and profits.

It is possible for increases in taxes to stimulate spending. Thus, the recent repeal of provisions of the Accelerated Cost Recovery System, which would have become effective in 1985 and 1986, could induce firms to make capital expenditures sooner because there are no longer additional tax advantages to be gained by waiting. One might add that if we were to legislate now the elimination of the investment tax credit to be effective a year from now, firms would have a substantial inducement to incur capital expenditures before the credit is lost. Were we to announce accompanying cuts in business income-tax rates effective a year from now, firms would have a further incentive to make deductible expenditures sooner at the still-prevailing higher tax rates.

Inflation and Budget Deficits

Inflation plays all kind of tricks, and not the least on federal budgets. As we have suggested earlier, budget deficits are not generally a cause of inflation. They are clearly magnified by recessions. But inflation does affect budget surpluses and deficits. Some of the effects have not been widely perceived or understood.

It is generally known that inflation tends to magnify federal revenues. Without indexing of the personal income-tax structure, the successively higher money incomes in the course of an inflation generate greater than proportionate increases in tax revenues. On the corporate side, and with regard to business income generally, inflation tends to raise Treasury revenues as taxes are levied on profits related to the higher prices of inventories and the excess of replacement cost over original cost depreciation. To the extent that capital gains are realized and subjected to tax, inflation also raises tax revenues from this source.

On the expenditure side, inflation raises outlays for a number of indexed programs, particularly social security payments, as well as general purchases of goods and services. And of considerable current significance, inflation and its concomitant of expected future inflation, by raising interest rates, increase interest costs on the federal debt. On balance, until now, inflation has tended to raise revenues more than expenditures, and thus has generally reduced federal deficits and pushed budgets toward surplus. The indexing of personal income-tax brackets, scheduled to begin in 1985, and the Accelerated Cost Recovery System with regard to business taxes will both contribute to reducing, if not eliminating, the excess of revenues over expenditures generated by inflation.

I should like to focus, however, on an effect of inflation on the federal budget that fundamentally changes the meaning of usually measured budget deficits. In so doing I shall point up some of the peculiarities of federal budgeting that lead to widespread misinterpretation of the impact of budget deficits on the economy.

Federal budget deficits essentially add to private holding of government debt. While the current flow of expenditures in excess of revenues is considered a short-run stimulus to aggregate demand, the theory of rational behavior would suggest that consumption and other spending may be substantially influenced by longer run considerations of income and wealth. In this sense, federal expenditures financed by borrowing generate private claims to wealth in the form of government bonds, whereas balanced budget expenditures leave taxpayers only tax receipts. The increased wealth in government debt induces more consumption, which will be realized in actual production of consumer goods if there is slack in the economy, but will engender only higher prices and inflation if there is full employment.

Some have argued that the increase in public debt will not add to consumer demand because households will view the eventual need to levy taxes to pay the interest and principal on the debt as offsetting the value of bond holdings. I doubt the substance to this argument, which would appear to demand assumptions about public and private discount rates, certainty and bequest behavior, among others, which have at best limited applicability.

But if there is any impact of private holdings of government debt on consumption and aggregate demand, it must surely be the real, rather than the nominal, value of debt with which we should be concerned. And that is where the peculiar role of inflation comes in.

The basic fact, well-known but not thoroughly assimilated in the present context, is that inflation aids debtors and injures creditors by reducing the real value of obligations fixed in nominal terms. As this becomes apparent with sustained inflation, lenders demand and borrowers must pay higher nominal rates of interest to induce the holding of debt obligations. The Federal Government, with over a trillion dollars of debt, of which not much more than half, however, constitutes net obligations to the public, thus on the one hand makes very large nominal interest payments but, on the other hand, enjoys almost correspondingly large capital gains, year after year, as the real value of outstanding debt declines. In our conventional accounting, however, we include the nominal interest payments as a government expenditure contributing to the deficit but we do not include the capital gain on existing debt, to which the interest payments are clearly coupled, as a revenue that would reduce the deficit. Hence, we measure nominal rather than real interest costs of the debt.

The Federal Government may thus run a substantial budget deficit, as conventionally measured, without increasing the public's real holdings of federal debt. But if holdings of federal debt in real terms do not increase, the public does not, as a consequence of the nominal deficit, have any long-run reason to increase its spending.

While inflation lowers the real value of existing debt, changes in rates of interest, whether induced by changes in expected rates of inflation or other factors, change the market value of existing debt. Thus, in periods of rising inflation and rising nominal interest rates, the real value of existing debt is reduced both by the increased interest rates, which lower market values of outstanding securities, and the higher prices, which lower the real values of the lower nominal market values.

These effects are far from trivial. After subtracting financial assets and adapting or constructing appropriate indexes for converting values of securities from par to market, Paul J. Pieper[1] and I have developed a series for the federal budget surplus and deficit, adjusted so as to correspond to changes in the real value of the net debt. For 1980, for example, when the National Income Accounts showed a federal budget *deficit* of $61.2 billion, our adjusted budget showed a *surplus* of $7.8 billion! The entire time series reveals that, while as commonly observed, the federal budget has been in deficit as conventionally measured in most years, the real value of the net debt has been declining. Per-capita adjustments indicate even more sharply the reduction of debt. At the end of 1946, the net debt per capita was $3,338 in 1972 dollars. By the end of 1980, it was less than a third of that—$1,078 in 1972 dollars.

The usual notion of a budget deficit, for good or ill, entails increasing debt. Indeed, in nominal terms, one can write the par value of existing debt at any point of time as the integral of all previous deficits minus surpluses. But unless we are to be guilty of money illusion, which economists and the rational public should be expected generally to eschew, we must recognize that it is changes in the real, market value of debt that must matter. If federal budget deficits are to have most of the economic significance attached to them, they should be measured so that their sum or integral over time equals the total debt.

It is significant to note that corresponding adjustments to measure an economically relevant federal budget surplus or deficit are in order for the high-employment budget. Such adjustments put interesting new light on the likely thrust of recent fiscal policy. Various mixtures of surprise and alarm have been expressed at the failure of alleged fiscal stimulus to prevent recessions or stagflation despite reductions in the high-employment budget surplus that have extended so far in some periods as to produce high-employment budget deficits. This has perhaps led to the inference that fiscal policy is relatively impotent, with a tight money policy clearly dominating an easy fiscal policy.

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In the 1950's and early 1960's, inflation and rates of interest were generally low so that the reported high-employment budget surplus required relatively little adjustment to correspond to changes in the real value of the debt. The increases in inflation and interest rates in recent years through 1981, however, have been another matter. The high-employment budget surplus, adjusted to reflect the resultant changes in the real value of debt, has been substantially and, in much of the period, increasingly, in surplus. For 1981, our adjustment changes the official high-employment budget from a deficit of $2.6 billion to a surplus of $65.6 billion. Even the 1981 fourth quarter official deficit of $38.2 billion would, with adjustment, become a significant surplus. If the high-employment budget offers a first approximation of the thrust of fiscal policy, the appropriate adjusted measure of it suggests that we have not in fact had an expansionary fiscal policy, despite the recent tax cuts that have been so widely hailed in some quarters and deplored in others. Our adjusted measure of the high-employment budget surplus suggests that the current recession may be the consequence of an overly tight monetary policy, apparently supported by many as a necessary corrective to the illusion of an overstimulative fiscal policy.

There are many important improvements to be made in our accounting for federal expenditures and revenues and construction of a federal budget. These should certainly include full capital budgeting and accounting for acquisition of assets, real and financial, as well as the incurring of liabilities. Appropriate measures of *net* federal debt and net worth will differ widely from the figures of budget deficits and public debt so much in the public eye. They are likely for many purposes, though, to give a much better indication of the financial situation of the Federal Government and its impact on the economy. But if we are to continue to be influenced by our perceptions of the bottom lines in federal budgets as currently calculated, we might at least note the tricks that inflation is playing. If we continue to view as expansionary federal budgets that are not, we shall have a poor guide for public policy. We shall misunderstand both the causes and the potential cures of phenomena such as our sharp and deep current recession and high unemployment. We shall also misjudge developing trends and needs for the future. A particular case in point would be our reaction to high-employment budget deficits a few years from now if they are brought about with more modest inflation and lower, relatively stable, interest rates. For in that situation, a high-employment budget deficit might truly be expansionary, and perhaps overexpansionary, from the standpoint of maintaining stable prices.

Conclusion

In suggesting that economically relevant measures of the federal budget may well be much less in deficit or more in surplus than has been generally perceived, we may be thought to be encouraging those who would feel free to increase government spending or reduce taxes. Increasing government spending for a number of social purposes, or at least curbing the sharp decreases that have been undertaken and are in prospect, would have important implications for the distribution of income and welfare. Increasing military spending or reducing the pressure to curb it may have quite different implications for both the distribution of income and our collective welfare. (I hardly mean to see these arguments used to reduce efforts to avoid further acceleration of the arms race.)

My reading of the struggle on the federal budget is that, all rhetoric aside, it really relates much more to the distribution of our Nation's economic pie than to its size. The current Administration in Washington has brought about great contractions in some areas of the federal budget while calling for very large expansions in others. While my own priorities on the allocation of resources are sharply different, my main concern in this paper has been to call attention to the impact of the federal budget on the size of the economic pie rather than on how it is cut up. Here it would appear that the grievous economic losses of the current recession may be traced in part to the active support by some—and undue tolerance by others—of an excessively tight monetary policy in the mistaken view that it was necessary to correct a federal budget incorrectly perceived as overly stimulative. It is important, for current and future economic analysis and policy, that we avoid such misperceptions.

2/7/84

Reagan, Regan and Feldstein

by

Robert Eisner

"As far as I am concerned, you can throw it away!" So spoke President Ronald Regan's Treasury Secretary Donald Regan about the Economic Report just released and largely written by the Chairman of President Reagan's Council of Economic Advisors, Martin Feldstein. How can there be such divided counsel within the Administration?

A simple answer might be that it is the economists, or at least the main body of the economics profession, on one side, and the politicans and non-economists on the other. While there is a large amount of truth in that, the story is a bit more complicated.

It has been said that God gave two eyes to economists so that they could use one to watch supply and one to watch demand. And indeed for a firm or for the economy, we see that supply indicates the resources that can be put to work producing goods and services and, given supply, demand indicates what will actually be produced. In a perfectly competitive, well-functioning economy prices then serve to clear markets so that quantities supplied equal quantities demanded.

But in 1981 there came to Washington the so-called "supply-side" economists. According to them what was holding back the economy was taxes which reduced the supply of productive resources. By lowering taxes on business we could increase the supply of capital. By lowering marginal tax rates on individual incomes we could increase the supply of saving and increase the supply of labor.

The idea was that business faced with lower taxes -- either because of a vastly accelerated tax depreciation system or an extended investment tax credit -- would invest more. Individuals, recognizing that the income on the money they saved would be taxed less or, better, that income could be excluded from current taxation by saving it for retirement, would be induced to save more. And the non-employed, including presumably the unemployed, would take jobs once they realized that enough would be left in their pay checks, after taxes, for it to be worth their while to work.

There also came to Washington in 1981 a group of economists known as monetarists. Just as they looked at both supply and demand, most non-monetarist economists also looked at both monetary policy and fiscal policy -- or government spending and taxing -- as having important effects on total output and employment and on inflation. But monetarists, at least in their pure breed, argued that it was only money that mattered. We could thus cut taxes all we wanted, create any deficit no matter how large, and have nothing to fear as long as "the money supply" did not grow too rapidly or capriciously.

Now the supply siders agreed that keeping down the rate of growth of the money supply would hold down inflation but they did complain that holding it down too much might depress the economy and cause or aggravate a recession. Their argument about deficits, however, was also "not to worry": the lower tax rates would so increase investment, employment and income that total tax revenues, net of unemployment benefits, would actually rise and the deficits would disappear!

On top of all this were President Reagan and the political philosophers around him. They had two profound sets of beliefs, that there must be a massive increase in the rate of military expenditures and that the non-military role of government must be vastly reduced. As long as the military rise was on track, cutting taxes, by raising public concerns about budget deficits, could only strengthen the drive to cut non-military expenditures.

Initially the military expenditure increases were modest. Perhaps more important, real taxes were higher than most analysts recognized. We were paying a huge "inflation tax" in the loss in real value of existing, publicly held federal debt. And the loudly proclaimed tax cuts, phased in only slowly, were at first more than matched by increased social security taxes and the higher income tax rates into which we were propelled by inflation.

Hence we were pushed into a very sharp and deep recession, with unemployment peaking at almost 11 per cent, its highest level since the Great Depression of the 1930's. The tight money and tight fiscal policy combined in a massive anti-inflationary overkill.

But by the middle of 1982 the tax cuts were in full force and the inflation tax was reduced as well. Most economists, except those of the monetarist persuasion, must give these tax cuts and the associated deficits major credit for the sharp economic recovery of 1983. They do so not on the basis of supply-side factors, which are at best forces that operate in the long run when demand is not a serious problem. Rather they recognize that aggregate demand has been greatly increased by the combination of monumental military spending and tax cuts which simultaneously encourage private spending.

And that sets the stage for the current disarray and conflict within the Reagan Administration. Treasury Secretary Regan and the supply siders and monetarists around him acknowledge no great danger in current and currently projected large deficits. Certainly they do not warrant, in their view, either reducing the President's military buildup or repudiating his tax cuts. In an election year one can hardly countenance deficit reduction in the one other possible way -- major cuts in the vast social security programs affecting the middle classes.

Martin Feldstein -- and the great majority of professional economists -- recognizes that while high government (military) spending and high private spending encouraged by lower taxes and deficits can serve a useful purpose in getting the economy out of a deep recession, continuing deficits of record-breaking proportions, after recovery is complete, are another matter. For then, as demand gets well beyond feasible supply, prices and inflation begin to surge. The Federal Reserve, again seeing itself as the only game in town to fight inflation, holds back on the money supply and nominal and real interest rates rise.

With military spending high and rising, public and private investment as well as real consumption must then suffer. And with the new decline in investment, superimposed on the substantial losses in capital formation during the recession, go the prospects for balanced, long-term growth.

Forthright as he is, it is that which Feldstein might say Regan -- and Reagan -- are on the verge of throwing away.

Representative **Hamilton**. Thank you very much, Mr. Eisner. Before we turn to questions, I think we will go ahead with Mr. Klein's testimony and then we will direct the questions to both of you.

STATEMENT OF LAWRENCE R. KLEIN, BENJAMIN FRANKLIN PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.

Mr. **Klein**. Thank you, Mr. Vice Chairman. Together with my friend and colleague, Robert Eisner, I express appreciation for the opportunity to put some views before this distinguished committee.

By way of summary, my presentation first looks at the present economic situation and agrees with the general assessment that we are definitely in a rather good recovery pattern at the moment and one can cite many favorable factors—the steady and relatively low inflation, the declining unemployment, the continuing growth in production. I think that we can also be encouraged by the January figures, or even possibly the February figures, that there really has not been very much of a slowdown so far in the recovery. People react much too seriously to 1 month, bad or good, and the early figures for 1984 suggest we are on quite a good track at the present time.

Now in spite of the fact the movement of the economy—and I would stress movement rather than its total position—looks very favorable at the present time, there are two very serious imbalances. The serious imbalances can be exemplified by an abnormally, and almost grotesque, large domestic deficit and also a large external foreign deficit. At the same time, I would point out that, while the American recovery looks very good at the present time, the world recovery is not all that strong and is very much dependent on the American recovery. We have a very unbalanced situation domestically with these two deficits and throughout the world there is a very unbalanced situation, in which we are practically the only industrial country that is in a vigorous recovery movement. Everybody else is depending on this.

So, very naturally, people ask the question: Is our recovery durable? Meaning not this month or this year, but the next 2 or 3 years. I would say that the presence of the deficits presents a very serious time bomb that is ticking away.

And the second issue, apart from the deficits, is that in most of the fiscal planning and budgetary analysis, certainly from the administrative or executive sector of the Government, there is no allowance for the natural forces of the business cycle. That has been a pernicious surprise to administration after administration and it is a fundamental property of our kind of economic system. We should plan for the uncertainties of the cyclical possibilities.

Therefore, we have two problems to face up to. We have the problem of the deficit and the problem of future cyclical movements of the economy. The way the deficit problem is shaping up it will intensify the future cyclical problem.

The deficit may or may not, in philosophy, be a bad thing, but if people perceive it to be bad and if security markets function on the supposition that it is bad, then we are in for trouble. That is precisely the trouble that occurred in 1981, to some extent in 1982. The security markets did not like the deficit and they did not like the mix of the deficit and monetary policy. That is really what brought on the recession out of which we are just beginning to climb.

We are heading for a similar kind of problem and I cite two precedents in this paper. One precedent is that in 1980 when security markets did not like the budget, it was revised and resubmitted. A message was given, and the message was accepted and action was taken on it. Also, I would cite the precedent that when the economics profession at large was giving a warning to the political leaders and policymakers and this warning was unheeded that it was bad for the country. Although you could not see immediately the effects of the warning, the warning was correct and in a longer term sense it would have been better to act on it.

We never agree totally among professional economists, but there is a very broad agreement now that something should be done about the deficit. It should be brought down. It is very bad for the country that the policymakers should not be paying attention to this warning. It is so widespread and so well impressed on the minds of people who think about these problems seriously, that the policymakers really should be taking heed.

Now what could be done about the situation? I suggest that we should look at the problem from at least two points of view. One point of view would be in terms of macroeconomic policy, the aggregate approach; and there I would say the remedies are relatively straightforward. We have the wrong mix between fiscal and monetary policy, and we should adopt some fiscal policies that are directed more toward reducing the deficit. Those are quite obvious, and Robert Eisner stated them quite clearly. You raise taxes and you cut spending and you have various combinations of both. That would be a way of reducing a deficit.

At the same time, to reduce the deficit would be a burden on the overall functioning of the economy, and we need the other part of the mix, an easier monetary policy. The experience in 1982 suggests that this would be a very good combination because in 1982 when certain fiscal measures were taken or promised, the Federal Reserve did become more lenient, and that was the signal by which we managed to get emergency levels of interest rates down from about 20 percent to the neighborhood of 10 to 12.

These two policies could go together very well, and I presented a calculation with the assumptions given in my table 1 of what would constitute a changed fiscal and monetary policy mix. These are by no means unique, but this is just one set that has possibility, in which taxes are raised both at the personal and the corporate level, defense spending and transfer payments to persons are cut, and monetary policy is easier, bringing down interest rates in the order of magnitude of 200 basis points. With this new mix of monetary and fiscal policies, as I indicate in table 2, the Wharton econometric analysis shows that we can have a better economy in the sense that we have a more balanced situation. We do not make enormous improvements over where we are now or where we are heading for the moment, except that we can bring the deficit down considerably, take this worry off people's minds, and also bring down the external deficit because if we were to lower interest rates we would probably bring the dollar down. Eventually that would begin to turn around our current account deficit much as it did in the period after 1977-78 when the dollar fell. A few years later we moved into current account surplus.

So I think we could make considerable improvement over the two deficits, and the other major achievement of a policy change like this is to lessen the danger of the business cycle contraction that would come in the normal course of events around 1986. We probably could not eliminate it entirely, but we could moderate it.

These would be, in my opinion, the way to move on policy, changing the mix, and getting a much more well balanced economy. I would say that there is no good economic reason for delaying the implementation of this kind of policy. No time is better than the present to initiate it.

Now, I would end by pointing out that these do not really solve all our problems. I think we have some deep-seated economic problems. The only way to get at the deeper problems, in my opinion, would be to go beyond macroeconomic policy. Just playing with the budget, with expenditure-tax combinations, and monetary policy combinations, will not be enough. I would suggest that that really brings us into the realm of something that is more controversial but still very much under debate, namely, industrial policy; and I, for one, would advocate rather activist and vigorous industrial policies or structural policies that go beyond switching around of the aggregates if we are to get the kind of recovery that we really are looking for as a target.

Thank you.

[The prepared statement of Mr. Klein follows:]

PREPARED STATEMENT OF LAWRENCE R. KLEIN

Rarely has the overwhelming advice of economists been so ignored by policy makers as it is today. The great majority of economists in thinking about present tendencies in the economy, about the present choice of economic policies, feel that the large federal deficit now being incurred and being projected far into the future require immediate implementation of policies to bring about a less unfavorable matching of outlays against receipts.

Two precedents immediately come to mind. Economists recommended tax increases to pay for the costs of the Vietnam War, as early as 1966, but action on their advice was delayed for two years, and the roots of inflation began to take hold, much to the disadvantage of economic performance of the 1970s.

In early 1980 when deficits had just been reported at amazingly low figures — less than $30 billion in FY 1979 on a unified basis and less than $15 billion on an NIA basis — financial markets reacted unfavorably on contemplation of proposed budgets, and the administration were forced to reconsider their position. They put together a new budget. Markets are presently giving the same signal again, and the administration ought to show the same degree of flexibility in heeding the warning.

Many aspects of the economy look favorable at the present time. The 15-month old recovery is continuing; the inflation rate is at a very low level; unemployment is falling; and productivity growth has resumed.

But all is not well with the economy. The federal deficit figures are ridiculously high. These represent a time-bomb ticking away to create eventual explosive trouble for the economy. That is why professional economists are worried, and that is why policy action is imperative now. The personal saving rate is low; that makes a bad combination with the federal deficit. Fortunately it is being offset by the flows of retained corporate earnings, funds for capital recovery, and funds from abroad. At least some of these funds are volatile; therefore action should be taken immediately to bring about a better balance in the capital market between sources and uses of financial funds.

Interest rates have stopped falling and are short of the position where they should be in order to ensure the steady progress of the recovery. The perception of excessive deficits by the financial markets keeps interest rates elevated, and this is the fault of policy inaction for bringing the deficits down.

There are two deficits, one internal and the other external. Just as the internal deficit poses a problem of economic imbalance so does the external deficit, namely, the negative current account balance. The U.S. dollar is the key currency for many world transactions. Many basic commodity prices are denominated in dollars. Many loan agreements are serviced in dollars; most comparative statistics across countries are quoted in dollars. It is very important to have a stable measuring rod; that is what our partner countries want of us. We cannot provide an environment for a stable dollar in foreign exchange with a merchandise deficit of $70 billion or more and a current account deficit of some $40 or $50 billion. Remedial policy action is required here as well.

The Outlook

The Wharton Forecast for the nation indicates that the recovery should continue through 1984. On a year-to-year basis, the growth projection is impressive at more than 5.5 percent but the spread between 1984.4 and 1983.4 shows a gain that is under 5.5 percent, and the annualized quarterly rates are expected to decline steadily after mid year. Unemployment should continue to fall, and the rate of inflation should remain moderate, rising to only 5 or 6 percent.

Not only do we at Wharton look for continuing recovery in the United States but also in the world at large. Only two areas of the world have shown strong growth in 1983, namely, North America (excluding Mexico) and the Pacific Basin (exluding Australia, New Zealand, the Philippines, and Indonesia). But we do expect to see the recovery spreading to Europe in 1984 and 1985, to Latin America in 1985, and to some other areas that are now on a slow track. By 1985, the recovery should be widespread throughout the world. In one sense, it is a good recovery because it is taking place at a low rate of inflation. In another sense, it is a poor recovery because it is leaving a large residue of unemployment.

Recoveries do not last forever. In the normal course of the business cycle, one of the most persistent phenomena of economic life, we can look for a downward correction about every four years. The Wharton Forecast estimates a growth recession in 1986, but the turn could actually come as early as 1985 or as late as 1987, but come, it will.

This forecast is a statistical projection, and like all such constructs is subject to error; that is why the ticking time bomb is a serious danger. There are non-negligible chances that the deficit could generate higher interest rates than forecasted; this would stifle investment again, and make the next recession more severe than a mere gorwth slowdown. It would also make the deficit figures much worse because recession and high interest rates cause deficits to balloon. Interest payments alone are already at about $100 billion and rising steadily. Of course, things could work out better than forecasted, and the deficit could be lower, but even in the best of circumstances, it does not appear that the deficit can be brought significantly under $100 billion, and that is a pretty poor show, especially in a recovery period.

The dollar is expected to fall, under the weight of the large current account deficit, and when it does, the trade imbalance is likely to get worse before it gets better. That is what happpened in the previous occasion of dollar decline. But eventually the low dollar stimulated exports while it restrained imports. This helped to turn the current balance from deficit to surplus. We expect to see a similar pattern in the near future.

The danger of perverse developments in the United States, through the deficit's leading to high interest rates and a setback to investment, would be an explosive situation for the world economy. This country has been leading the world economy in recovery but has the ability to plunge the world back into recession. In particular, another round of high interest rates would impose a crushing burden on service payments for debtor nations. Not only that, we could become a debtor nation, too, unless we keep interest rates down and continue the recovery. The ticking time bomb poses a threat to the stability of the whole world economy, not just to our own system.

What Is To Be Done?

The first steps are procedural. Take heed to economists' advice; listen to the message of financial markets and, above all, cut your losses by recalling the budget and resubmitting one that is both more realistic and more prudent. It does not make sense to ignore the teaching of economic wisdom. A business cycle downturn is likely to occur by the end of 1986; therefore, allow for such an event in budget planning. The CBO document of February 7, 1984 does just that. Their low forecast allows for a sharp decline in GNP in 1976. This scenario produces a deficit above $300 billion by FY 1987. In the best of circumstances, at the other end of their band of uncertainty, they project, for the high scenario, a deficit of about $180 billion. This is the range in which the policy debate should be conducted.

The next step should be substantive. The overall formula should be to change the policy mix by tightening fiscal policy and loosening monetary policy. The former would help to improve the deficit and at the same time, make it possible for the Federal Reserve authorities to become easier on monetary policy. That is just the twist in the mix that occurred in summer 1982, and helped spur the recovery.

The Wharton Model has been simulated for an exercise that changes the mix between fiscal and monetary policy. It contemplates increases for personal and corporate taxes, cuts in defense spending and lower interest rates through increases in unborrowed reserves, and dollar depreciation.

Table 1

Main Assumed Changes for New Fiscal/Monetary Mix

	1984	1985	1986
Personal income tax (federal, $bill)	3.8	18.8	30.0
Bond yield (AAA, % points)	-0.39	-2.94	-2.42
Treasury bill rate (% points)	-0.08	-2.33	-1.47
U.S. dollar exchange rate (% over baseline)*	1.3	10.0	10.0
Defense spending ($, bill)	-2.5	-12.5	-20.0
Federal transfers to persons ($, bill)	-2.5	-12.5	-20.0
Corporate tax rate (federal, % over baseline)	1.4	6.9	11.0

*weighted average against 7 major countries

The guiding philisophy of these changes is to impose (at the end of 1984) tax increases at both the personal and corporate level, to reduce defense spending (eventually by $20 billion annually), to cut social spending (transfers) by the same amount as defense, and to get, in return, easier monetary policy from the Federal Reserve. This translates into declines in long and short term rates (eventually by 200 to 300 basis points), and another 10 percent dollar decline. In the baseline case, the dollar drops by 0.5% in 1984, 4.6% in 1985, and 3.2% in 1986. It would probably drop if interest rates were to come down, as in table 1.

In a sense, this exercise assumes that an accord is reached between the Treasury and the Federal Reserve, with cooperation from Congress. There are other minor changes in this particular calculation, but these are the principal ones.

The policy is programmed to begin during the fourth quarter of 1984. Corresponding to these assumed changes, the Wharton Model forecasts response in in the main indicators of economic activity. Their new values are liseted in Table 2.

Table 2

Outcome: New Fiscal/Monetary Mix

Some Main Indicators

	1983	1984	1985	1986
Real GNP(%)	3.3	5.3	4.0	3.8
Unemployment (%)	9.6	7.8	7.2	6.2
Current account ($bill)	-39.7	-64.8	-66.7	-29.1
GNP deflator (%)	4.2	4.6	5.2	6.8
Productivity change (%)	3.1	2.7	1.8	2.1
Change in M1 (%)	9.6	5.7	5.6	6.1
Treasury bill rate (%)	8.6	8.6	8.0	9.5
AAA bond rate (%)	12.0	11.7	9.6	10.0
Consumer expenditure (%)	4.2	4.4	1.8	3.0
Business fixed investment (%)	1.1	12.5	8.2	7.9
Deficit ($bill)*	195.3	177.4	152.7	86.4

*Fiscal year

The principal effect of the policy switch is to smooth out the coming recession by having monetary policy contribute to better investment growth, while fiscal policy changes the deficit picture. By 1986, both deficits look better. The internal deficit is estimated to be less than $100 while the current account deficit falls to less than $30 billion — under last year's figure. There is an expected growth slowdown in 1986 but it is much milder than in our base case, structured on present policies.

While we do not look for as weak an economy as in the CBO's low case, where a real decline is assumed to occur in 1986, we do project low quarterly values of growth (at annual rates) of less than 1.0 percent in some individual quarters. The lowest quarterly value underlying the figures for GNP growth in the above table is 1.8 percent, estimated for 1984.4.

Unemployment steadily falls; prices rise only gradually; productivity recovers; and interest rates come down before they edge upwards again. All in all, this is a much healthier and balanced economic environment. It represents, in a sense, a goal or target.

The particular changes introduced in order to alter the fiscal/monetary mix are not, by any means, unique. Other desirable patterns can be found. There are many ways of cutting spending, raising taxes, or helping our net foreign balance. There are many tax options that combine system reform on equity or efficiency grounds, and simultaneously increase revenue collections.

The overall macro policies considered in this paper just scratch the surface. Many lines of industrial policy are available for improving performance in special sectors of the economy or in helping the work force adjust to the new situation in modern, technical activities. The new technologies, standing in the background have their problems, too, but they hold promise for our possibly realizing a high-growth alternative, at least for some of the period during next 4 to 8 years.

Representative **Hamilton**. Well, thank you very much, gentlemen.

What is the probability of a recession in 1984?

Mr. **Klein**. Well, I would put that rather low at the moment. We never really rule out, with 100 percent probability, any kind of movement in the economy and we would be in for unfortunate surprises if we go on the supposition that we know these things for certain, but the economy is very vigorous at the present time and we will get some reinforcement from the pickup that we have already started, as a locomotive, in the world economy. Many countries have got their own economic problems in better order—inflation has come down around the world—not everywhere, but on the whole—and I think we would be a partner in a more general expansion which is getting underway.

There is a recession danger definitely along the way, but not as early as 1984.

Representative **Hamilton**. Is that your view or is that the general view now of most economists?

Mr. **Klein**. I think that is a general view. Of course, there is one outside view—that would be a doctrinaire monetarist view which said that we had too much of a slowdown in the money supply figures late in 1983. That, according to their simplistic rule, would foreshadow a decline in 1984. However, the numbers have been revised upward since and their view may be attenuating somewhat now.

Representative **Hamilton**. Chairman Feldstein says that we ought to take deficit reduction steps in 1984 but they ought not to take effect until 1985. Do you agree with that position?

Mr. **Klein**. In my opinion, that is a political position. Good economics would say, start tomorrow reducing the deficit. There is no reason to wait at all, and recovery is very strong. Indeed, that was the whole position in 1983. People rejected doing anything about the third phase of the tax cuts because they did not want to stop the recovery, but the recovery was so strong and there were so many good timing reasons in terms of income tax rebates by the way the 1982 tax cut was phased in, and just miscalculation on the part of a lot of forecasters that fiscal restraint could have been started already. That also led people to believe that it was too early to start budget or deficit reduction in 1982. I think that was totally wrong for 1983 and it is totally wrong for 1984.

Representative **Hamilton**. Mr. Eisner.

Mr. **Eisner**. I confess, perhaps unusually, I do not fully agree with Mr. Klein on that. I agree with most of the other things he said, including his forecast on the recovery. I think we are clearly recovering and in a strong recovery, although we are far from fully recovered. The unemployment rates being what they are, I would not want to jeopardize that recovery in any way.

My own priorities are such that I think it is very important to keep the recovery moving, keep employment rising, keep output rising, and on this I would agree with Mr. Feldstein. I think we can get all the benefits that Mr. Klein looks for in terms of altering the mix by legislating now reductions on the deficit in the years ahead, and that should be an adequate signal to financial markets and hopefully the Federal Reserve to ease further on its monetary policy which would then lay a groundwork for balanced growth.

Representative HAMILTON. Is your view basically that the recovery is so fragile at this point that a deep spending cut or tax increase would jeopardize it?

Mr. EISNER. Well, it is not that it is so fragile. It is partly a matter of the weights I attach to different possibilities and partly really picking up on what Mr. Klein said, that we really never know. We are always playing a kind of probablistic game and I just would not want to increase the probabilities that the recovery would be slowed, that unemployment would stay at least at this plateau without going down further, if not rise, I think that is a danger one should not get into lightly.

It is true, I recognize, that this suits certain political purposes, but just speaking, it seems to me from the best opinion I can offer as an economist, it is not a risk you take.

It is like a patient who has had a terrible disease and is recovering now and you say, well, should we stop the medicine and figure he is well enough on the way to recovery so that it will not matter. I think that the medicine which has contributed very greatly to getting us into the recovery, as much as we deplore it on other grounds, has been the deficit. It has poured a great deal into the spending stream and all our economic analyses indicates that that is a stimulus. As I think we still could use it I do not want to take it away.

Representative HAMILTON. What are the risks of big deficits? Your language, Mr. Klein, is rather unusual—a time bomb ticking away, you used the phrase "explosive" a few times. Now for a restrained academic, that is pretty strong language. What is so explosive about these deficits? What chaos is going to come upon us if the time bomb explodes?

Mr. KLEIN. Well, we saw that happen. Credit markets move very fast when they see trouble ahead and you could have an adverse runup in interest rates over a few months' period or even a shorter period of time. We did see that happen in 1981 and almost again in 1982.

Now the explosive things are the following: We could eventually get to the point at which we are going into a normal recessionary movement along the way just by the economy's own rhythm. That is a complicated thing to explain, but there is a whole body of scholarly information on why we have cyclical movement, and I am a strong adherent to that point of view. If we get financial markets rejecting the financing of the public debt as it goes on and on in this explosive manner, then we could have another quick runup in interest rates and make the situation much worse.

Now I also believe that in the summer of 1982 the whole world financial system was critically close to collapse, and I do not think people appreciate how serious that situation was. There are many developing countries that cannot meet their present debt payments. We know that. We just began to realize it at that time. Another runup in interest rates will be crippling. It will bring this whole crisis to the fore again.

We are just at the point—not of having solved it but of having cooled it off and having put it in a controlled situation, in which new loans are being made to pay the interest on the old loans. We know that. A rise in interest rates again will kill that whole process.

It has only a dubious chance of succeeding and we would kill its chance if we were to have an adverse reaction again. Those are the time bombs.

Representative **HAMILTON**. Well, spell out the implications of that for me. Suppose you do get an interest rate increase. Suppose you do get the situation where these debts cannot be paid. What happens?

Mr. **KLEIN**. Well, first, we have a possibility of financial panic. Nobody wants to re-create 1932 again. That may be overdrawing the situation, but even if we had a 10-percent probability of re-creating that situation we should do our best to avoid it. People become confused and bewildered. What are the depositors in our major money market banks going to think if it suddenly becomes clear that billions, literally billions, of dollars of loans are not going to be repaid? And whether or not that is a serious dilution of their own position, of either the stockholders or the depositors in the banks, they may react in a completely frightened way.

In addition, there are not enough reserves in the great insurance system that we have on bank deposits to cover anything like a total run on the banking system. We should have to run the printing presses all night to meet the full letter of the law and give everybody back their deposits if they really demanded them. So we run all kinds of probabilities of getting into situations that we do not have the faintest idea about how to deal with. This is the frightening aspect.

Mr. **EISNER**. I guess I do not place that much concern there. I guess I would not differ with Mr. Klein's characterization of the looming deficits as a time bomb, but I would say it is not that large a time bomb, and the problems he suggests I think are problems that can be met and the question has to be, what are the alternatives.

I think problems of interest rates, of solvency can be met by appropriate action in part by our own monetary authorities and in part by some kind of a world concerted action.

The difficulty I would think, getting back to basics, is that the deficits will create a situation of excess demand as best we can calculate, given all the uncertainties as to where the economy would be without these deficits. It looks like that is too much demand and that is going to be met by the economy unadjusted or by the economy with intervention. It will be met by inflation and that in itself will contribute to high nominal interest rates and to the extent the Federal Reserve clamps down the nominal interest rates will be all the higher and real interest rates higher. I think that is the most we can say.

There will be dislocations as we have with any kind of a change in prices, change in interest rates, and a dislocation that Mr. Klein talks about in international markets is very real, but they indeed can be met. You can bail out countries. In fact, it is very standard practice to make new loans to finance the repayment of old loans. It is done by almost every business. It is done by governments. It is done by the Federal Government. And we can help the underdeveloped countries do that.

However, if we take action that creates a recession, that kills our recovery, then that would kill the recovery, as I think Mr. Klein has pointed out, in all the rest of the world and the underdeveloped countries would take all the worst beating.

So, I think it is important that we keep a perspective on this. I think the economics profession is agreed that the looming deficits are bad, but we have to understand precisely how they are bad. I think it is foolish to say, as I read, Mr. Stockman has said that we are at the point of national bankruptcy like a company filing for bankruptcy. It is a mistake to say that the deficits clearly are going to cause a recession in themselves. They do not cause a recession. Indeed, they tend to drive up interest rates because they are causing demand to be so high that the markets tend to compensate for this and reduce demand by the process of inflation itself, and by the process of higher interest rates.

Now again, it creates uncertainties and, depending on Government policy which can get foolish—I think a very tight monetary policy would be foolish—you can work your way into a recession that way. But it is not an automatic consequence of deficits that are too large.

Representative **Hamilton**. I want to come back to this inflation question. Let me turn to Congressman Hawkins.

Representative **Hawkins**. Thank you, Mr. Vice Chairman.

May I first of all express my appreciation to both Mr. Eisner and Mr. Klein who participated with us in that period just before 1978 that brought about the Full Employment and Balanced Growth Act. As you well know, in conjunction with Senator Humphrey, we did hold hearings throughout the country and we did have hearings before the various committees, including the Joint Economic Committee and other committees of Congress on both sides, on this side as well as in the Senate, and we did, as a result of that, introduce and the House approved as well as the Senate and the President signed the Full Employment and Balanced Growth Act, setting the goals that we thought were rather reasonable. I think there was some slight difference. I think Mr. Schultz, representing then President-elect Carter, differed on whether the goal of reducing unemployment should be 4 or 4.5, but at least he was very close to agreeing that the 4 percent, with the other provisions in the act, was a reasonable goal.

Now apparently we have moved in the opposite direction in that we have had two rather serious recessions since then and we seem not to have agreed that we could accomplish the objectives—that is, reducing unemployment to a reasonable level, at least as an interim goal, and at the same time achieving price stability.

I am somewhat confused as to where it is that we went wrong. Why is it that we have gone in the opposite direction with those goals and why is it that today we are being bewildered because we do not know what the economic policy is and it depends on who is talking for the administration and we are getting ourselves into a rather serious situation that Mr. Klein describes as an explosive situation; and I think you, Mr. Eisner, while you do not go as far as he goes and are a little more optimistic, your optimism is couched in a lot of "ifs" that are not likely to take place.

In speaking of the deficits, we have had a host of administration witnesses come before this committee in the last several weeks and in each instance they spoke about the deficits without fixing any responsibility as to whose deficits they are or who is responsible for them, and they indicated by implication—and I think that was repeated today—that in dealing with the deficits that you either raise taxes or you cut spending. That seems to be the general approach as to what you do about them.

Well, I suppose the implication of my question is, Is it a good thing to raise taxes at this time? Would that interfere with recovery, since in raising taxes we probably are going to do it in a very regressive manner, if we do it, which is not likely? And the other thing—cut spending—what spending are we talking about? Because in placing the deficits as the big issue that we go into this discussion revolving around, we get into the trap of using that as merely an excuse for cutting domestic spending and not dealing with the waste and mismanagement in defense spending, and that it ends up with cutting vital priority domestic needs in the budget.

Now that seems to be the alternative to allowing the deficits to continue.

I would like to ask both of you, Mr. Eisner and Mr. Klein, would it not be better to really face the issue of what caused the deficits; what are the major causes of the deficits; and just how do we go about reaching these basic causes?

Mr. EISNER. Well, I think the major causes of the deficit are fairly clear. There is a huge increase in military spending. There is a huge cut in taxes. And there is a recession. And those three account, indeed more than account, for the huge deficits that we have.

What to do about it? For one thing, by the way, and it is somehow not frequently mentioned, an easier monetary policy would quickly reduce the nominal deficit that we have. I think most people would agree that in the short run—I think in the longer run some people would argue—it would reduce nominal interst payments. That then would begin to reduce the payments of the Treasury which would reduce our measured deficit. It would also hasten the pace of recovery and sustain it better, which again would tend to reduce the deficit.

In terms of the structural deficit, there is probably a matter of political priorities and what we think is important for the nation. I do think you can make a good economic argument that it is important to maintain our capital, public and private, and that means that the cuts in expenditure should not involve cuts in government expenditures for health, education, roads, airport terminals, the facilities, the whole infrastructure on which the growth of the economy depends.

I might also add—and I think this, too, is frequently ignored—that we talk of cutting expenditures or raising taxes essentially really to reduce inflationary pressure and it then does make a difference what you cut. For example, cutting government expenditures for food stamps reduces the deficit but is clearly raising the cost of food to the people who were getting food stamps. Cutting government subsidies for mass transit is going to raise the cost of transit. Cutting expenditures for roads or airport terminals is going to increase the cost of transportation. There are then some government expenditures which actually tend to reduce prices and reduce costs and are an investment in the future.

Unless you are convinced that the high military expenditures are necessary to defend our capital structure and the nation, then sheer economic analysis makes clear that those expenditures are not reducing costs, are not going to be reducing prices; they do add to them.

There are similar arguments on taxes, taxes on telephones, on airline travel, on sales taxes on goods and services, these may reduce deficits, but they directly raise prices in the process and it is illusory to think that you are going to combat inflation that way. The taxes to be increased should be taxes that most clearly impinge upon demand and that should be kept in mind.

But I think the measures for reducing the deficits are clearly understood, certainly by economists and financial analysts. It seems clear to me, and I trust to everybody, that there is a game of political chicken going on and that the administration's position is that we leave this huge deficit and force somebody to take action of the kind they would not otherwise take. If they stand fast on the military and on taxes that will somehow force the Congress and the public to accept and go along with further cuts in domestic spending. But many people feel that such cuts in domestic spending are simply impossible or infeasible and that is where you are left.

Representative HAWKINS. I think your analysis is a very clear one. However, I think it is rather fictional to believe that anyone at this time is going to take any steps to institute the changes that you suggest and I think it is based on wrong analysis or at least a political analysis of what is wrong with the economy and what has been the real cause of the deficits. I think that there are even liberal Democrats in the Congress who have placed the deficit reduction as the main problem without any understanding or at least any effort at all to actually say what caused the deficits in the first place.

Consequently, it seems to me that any basis for optimism, if we are going to avoid the next recession, whether it takes place this year or the next year—it is obvious that it is going to take place soon.

May I direct the same question to Mr. Klein?

Mr. KLEIN. Well, as to the reasons for the large deficits we see now, I think I would agree with Robert Eisner's listing—the recession, the high military spending, the tax cuts and so on—and to a large extent that is arithmetic. We can all do correct arithmetic.

One way of putting the matter is the following: In the past, say 5 years ago or so, when we put our statistical models through an exercise to achieve a high rate of employment or low rate of unemployment in some near year, say 2 or 3 years hence, we noticed very quickly that the economy went into a situation of near budget balance. The numbers were not small. If we started with a $60-billion deficit and applied the stimulus, we would very quickly get toward a balanced budget.

Now we notice that whenever we make the same exercises we are always left with a very big deficit and the principal analytical reasons are that the tax system has been made so unresponsive, has been cut so much—taxes have been cut so much and they obviously, in my opinion, were overdone in 1981 and 1982 and 1983—and the military spending has been raised so much with the high interest rates—with very high interest payments by the Federal Government—that they all contributed very much to the deficit.

I think we can identify why the deficit is as big as it is. These things were going on for a few years.

Now can we devise a set of acceptable policies to bring it down? My answer is that we can find different mixes of monetary and fiscal policies that do so. Probably, from a political point of view, it would be best to have policy balanced, not to do all in tax or all in spending or all in one kind of spending or another, but to have it balanced because they are all in some sense painful to people. We should share these pains, and with a balanced program we can probably bring it down by half or a little better. It is going to be very difficult to bring it all the way back to balance. I am not at all saying that that is impossible, but it is very unlikely in the next 4 or 5 years to bring it back to balance.

If we had the leisure of looking at this to the end of the decade, maybe yes, but going out that far you run the risk of entirely new sets of circumstances coming to play that will unsettle it. Another oil crisis could unsettle it, and another round of problems with developing country debt could unsettle it.

So it is going to be a long process to get back, and I think that is one reason why I would emphasize that we cannot do all the things we want to do with the economy, with just the instruments of macroeconomic policy. We have to look to structural policies if we are to make any progress.

Representative **Hawkins**. Well, are the deficits really the cause of our difficulties or are the deficits part of the results of the policies which we have pursued which were wrong?

Mr. **Klein**. The deficit itself is not the cause. I think the only causal factor that I would attribute to the deficit is the way people preceive it, and especially the way credit markets perceive it. Their perception, together with the mix of fiscal and monetary policies that we had in the early part of this decade, meant that interest rates were driven up to abnormally high levels. That killed the economy and caused the recession. The recession itself is an enormous generator of deficits.

So that, I would say, is the causal sequence.

Representative **Hawkins**. OK. Thank you. I yield to the vice chairman.

Representative **Hamilton**. Thank you.

Well, on the inflation question, the budget for fiscal year 1985 says that fundamental factors are at work to prevent the renewal of inflation. The administration referred to a drastic reduction in inflationary expectations, the achievement of much lower inflation, and it talked about the demonstrated commitment of the Federal Reserve to control future inflation. It talked about labor and management having realized that inflationary contracts will not be validated by an expansionary money policy and so forth.

There is, in addition to the language in the budget, a lot of political rhetoric about having beaten inflation.

How do you perceive the inflationary threat as of today? I am always struck by the fact that when you look at inflation, even though it is a marked improvement over what we had in the latter part of the 1970's, it is still a very high rate of inflation historically and it is higher, I think, than it was when we had wage and price controls at one point in the Nixon administration.

So the question really is: Is inflation under control? How big a threat does inflation seem to you in 1984 and 1985? Let me add one other comment. I had the impression in listening to Mr. Volcker several times that he is still fighting inflation, basically: that is his concern, inflation. Where do you come down on this question?

Mr. EISNER. I should start by saying that economists, I am afraid, as the rest of us, have a very bad record on forecasting inflation. It is very difficult to forecast.

I do think that the administration and the country have benefited from the same quite fortuitous circumstances in one sense. That is, the driving force of the inflation in the 1970's was the huge runup in oil and petroleum prices and agricultural prices in world markets to some extent. That impetus has not only disappeared but was largely reversed. So that and the recession together did have a major impact in bringing down inflation; I have some impression that there is always a tendency to fight the last war.

I do think that inflation is down very substantially. It is perhaps even lower than some of the official measures because we have a tendency not to take into account productivity improvements adequately. So inflation is not a current problem of any magnitude. Whether it will become one is another matter. There, I would point with alarm to the increasing protectionist trend and the difficulty is that whenever——

Representative HAMILTON. What is the current rate of inflation?

Mr. EISNER. Well, current—there are different measures—3 percent, 4 percent, 2 percent, depending on whether you take the CPI or what we used to call the Wholesale Price Index, the GNP price deflator, whether it is growing over the year or quarter to quarter. I would say it is close to zero in many respects in terms of what is actually impacting the cost of living for many people.

Representative HAMILTON. Well, I had in my mind that the inflation rate was somewhere around 4 percent, and for you to say that inflation is not a current problem is a little surprising to me. I can remember when we used to get pretty excited about a 2- or 3-percent inflation.

Mr. EISNER. Well, I have to confess that I was one of those who did not think 2 or 3 percent was a great problem and I do not think it is particularly more than that at the moment, and I do not know if Mr. Klein is up on most of these figures, but——

Mr. KLEIN. Well, I do not want to go to zero with you, but I do agree it depends on which index one is looking at. For 1983, the CPI was 3.2 percent and the PPI was 1.7 percent, and the GNP deflator was 4.2. It is hard to give a single number, but I would say that it is in the neighborhood of 4 or 5 percent. There are some indexes that are a little higher.

Representative **Hawkins**. When you pay your food bill and medical bill and so forth, it seems to me like it becomes a rather serious problem.

Mr. **Eisner**. Well, in fact, the food bills have not gone up that much.

Representative **Hawkins**. Not that much, but they have gone up.

Mr. **Eisner**. I do not know why Mr. Klein said 4 or 5 percent after giving a string of figures of 2 and 3.

Mr. **Klein**. Because that was 1983 and we are now in 1984, and things are picking up a little bit.

Mr. **Eisner**. Well, actually, again, I think as to where we go, as I say, that is always unpredictable. For one thing, the big propelling force was and could again be an oil crisis that would give us a new shock wave and anticipations would react to it.

But if you take a look at the cost situation, have had restrictions on exports of Japanese cars to this country, and I am all for trying to save jobs, but that has not proven an effective way of saving jobs. What it has meant is a bonanza for Japanese manufacturers who have been able to drop all their concessions, keep their prices very high, and force you to buy all kinds of extra options that has put a protective shield on American car prices. What the American manufacturers have done—there was an interesting column by Tom Wicker in the Times just a few days ago pointing this out—has been both to keep their prices high and, to the extent employment was being stimulated, they would put people on more overtime and did relatively little in the way of recalling workers.

This whole trend of protectionism, which is partly a response to the very improperly high-interest rates and high value of the dollar, does then tend to keep prices up and means those prices that competition would force down do not go down and those prices that competition would force up go up, so the aggregate effect is higher and higher prices. And that, with the deficits, can create some threat for the future.

Representative **Hamilton**. Mr. Klein, I would like you to comment on inflation.

Mr. **Klein**. I take the view that inflation is a many-sided thing and it is wrong to think you can point at only one thing, either the money supply or expectations. I think that the expectational argument is self-serving, in many instances, by the people who say that that is what brought down inflation. I also think that it is very subjective, and there is very little chance of documenting that.

I would agree with Robert Eisner that raw material prices are a very important aspect. The history of inflation is very much tied in with the change in oil prices in the 1970's, with other commodity prices, agricultural and nonagricultural. One of the fundamental reasons why inflation came down so much in the last 2 or 3 years is a changed supply-demand balance in oil markets and raw material markets. That is likely to be with us for some time, in the sense that oil prices are not apparently ready to take off, at the moment, unless there is an unforeseen interruption of supplies because of military or other kinds of intervention. Raw material prices have come up about 20 percent in the last year but are not being stimulated into the very high rates of growth that occurred in the early 1970's.

Now the second aspect is the situation on the labor market, wages and productivity and unit labor costs. There, I would say, the productivity decline has been reversed, or the slowdown and the decline—they are quite different things—have been reversed. A lot of that was due also to the shock of adjusting to the new relative prices of oil and with some productivity gains we will not have such inflationary pressure as we have had in the past.

Now the primary reason why wage gains have been so small and moderate in this phase of the last 2 or 3 years is the high rate of unemployment. Even though it is coming down, it is still very high. And if I were to point to a subjective thing, I would say it is fear of job security more than inflationary expectations.

That job security fear is associated with a different attitude toward trade union pressure, toward trade unionism itself, and the tendency on the part of the Government and industry to take a much more aggressive stand against labor at the present time. This is definitely holding down wage increases.

We are getting the gains on productivity. Raw material prices are quiescent, and then if you put in a restrictive mood of the Federal Reserve, you have got the inflation picture. No one of those instruments dominates.

Representative **Hamilton**. The administration in its budget predicts a declining inflation during the period of recovery. Usually you see inflation going up with recovery, I think. What do you think of the administration's projection there? The other part of the question is: Would you anticipate inflation would continue to rise rather than fall over the next few years?

Mr. **Klein**. I would think it would be rising a bit, but there I would make the following statement: That while their forecast of inflation is on the low side and mine would certainly be higher, if you attach a proper band of uncertainty to it, we are not significantly different. I mean, to have an inflation rate that differs by 2 percentage points in 1986 or 1987 is not a big deal. From any scientific-economic-scholarship point of view, they are not different.

If you asked about 12 percent or 15 percent inflation versus 5 or 6 percent, then there can be significant differences. But we are all talking about the same range, and the administration chooses the lower point of the interval.

Representative **Hamilton**. It is unusual, is it not, to predict a declining inflation with a recovery in the period covered by the budget projections?

Mr. **Klein**. That is unusual and there would have to——

Representative **Hamilton**. Is there any historical precedent for that?

Mr. **Klein**. Yes; there probably is. In the early 1960's we came out of the recession and prices were very steady. They certainly did not rise and the economy was recovering nicely.

Representative **Hamilton**. What about this 4-percent unemployment that is in the Humphrey-Hawkins Act? Now is that really an achievable goal under present circumstances at all? The Congressional Budget Office uses a figure of 6 percent. The administration, I think, talks about 6.5 percent as full employment. What is an appropriate measure of full employment? Are we whistling Dixie to be thinking in terms of 4-percent full employment these days?

Mr. EISNER. I would think not, although it would take perhaps some measures other than we have had. I might just add—perhaps I am obnoxiously aggressive on this—I feel that most of the people of influence in the country do not really believe in full employment. I think there is a curious intellectual alliance between the old views of Karl Marx and views of classical economists. They just do not believe the economic system can function with a low degree of unemployment and Marx felt there had to be a reserve army of the unemployed to keep wages down so that business could make profits, and I think a lot of the business and financial community really believe that too. They believe that if you try to drive unemployment too low, that will drive wages up and that will drive prices up and cause inflation and all kinds of trouble.

With all due credit to Mr. Hawkins and the late Mr. Humphrey, I think a lot of people went along with that with tongue in cheek and did not really believe in the aims of the Humphrey-Hawkins Act even when they endorsed it and passed it.

I have, myself, felt not only that the aims are realistic, but they are imperative. They can be met. But one thing it means is that you really have to know what your priority is. If you say you want to keep unemployment down, it is inexcusable to try to stop an inflation by causing a recession, and that policy was begun in the Carter administration—fortunately, they were not very successful at it—and it was followed with a vengeance in the current administration. And that means they are consciously taking policies of avoiding those employment goals.

Now, what it does mean is adequate aggregate demand to begin with and then it does mean really taking measures to see to it that these huge pockets of unemployment among blacks, among young, among people coming out of the Armed Forces, and among people going back to the labor force after childbearing, whatever groups they are, you have to have measures to meet that. It means training. It means job placements. It means Government employment. It means employment tax credits for private employment and administrations and Congress have been very reluctant to face that. That has not been their priority.

Again, while I share the concern about the future deficits, all the talk is about deficits. All the talk is about everything else but really zeroing in and saying that's what we have to do; here are huge amounts of wasted resources.

So I think the goals are realistic. I think there has been a terrible tendency to simply revise up the numbers. As recently as the Vietnam war we had unemployment rates measured at about 3 percent.

Representative HAMILTON. Let me ask you this. Does that mean, then, that under current circumstances you would favor the kind of Government effort to get that unemployment rate down to 4 percent and the kinds of programs that you mentioned in your statement; in other words, substantially increased investment in education, in placement, in job training, in public employment programs?

Mr. EISNER. I certainly would.

Representative **Hamilton**. Now that is an enormous expenditure, I presume, but do you think it would be wise right now, with a $200 billion deficit facing us, to do that?

Mr. **Eisner**. Yes. I cannot talk of the politics, but I think it would be very wise. It is one thing to talk about a financial deficit in the budget; it is another thing to talk about the real output of the economy, and anything that raises the real output of the economy by investment in the capital structure is worthwhile.

A lot of that, if successful, will really actually end up reducing the deficit anyway because as incomes rise, tax payments will come in.

Representative **Hamilton**. Mr. Klein, how do you react to that?

Mr. **Klein**. Well, first, the number slipped from 4 to 6, which is the conventional number now I think, because people who kept moving it up felt that they did not want to undertake the effort to get 4 percent.

I always make it as an analogy to Senator Aiken's rule for Vietnam: You put down your guns and go home and say you won. In this case, if you cannot get down from 6 percent, you say that is full employment and walk away from it.

Now there are all the reasons that have been mentioned, dealing with abnormally high youth unemployment or unemployment among unskilled people who need skill training or education of one sort or another. Those are what I would call the structural policies that have to supplement the macropolicies if we are to make a real dent in the rolls of the unemployed.

But I would cite two more dimensions to the problem. One is demographic and that is that we got to this high figure of 6 percent, as a base, at a point when our thinking was guided by a very high growth rate of the labor force, especially to absorb the baby boom cohort. They came into the labor force just at the end of the 1970's and we were not really prepared to absorb that large number.

Second, the decision of women to enter the labor force at a higher rate occurred then, and so I think that that is probably going to level off a bit, and certainly the age cohort that followed the baby boom cohort is so much smaller that we have come down now to a position of about 1 percent yearly growth rate in labor force. If you give enough time—that is, 3, 4, 5 years—we can do much better about getting to the 4-percent target because every year it is getting a little bit easier because of the demographics.

Representative **Hamilton**. Would you favor the kinds of programs that Mr. Eisner favors be enacted now?

Mr. **Klein**. Very strongly, yes. I think those programs, as you said, would be very expensive and have to be well structured, and I am not at all convinced that public sector training programs are going to be the answer, but I do think they hold a lot of promise if they are put together right.

There is one other very big issue, and that is whether, in the medium term, we can afford a cut in the workweek. I do not mean a drop in the workweek for cyclical job sharing or unemployment sharing, but I mean a fundamental, long-term cut toward 35 or fewer hours per week, and as a society wants more leisure and as a society gets more productive, assuming that these productivity gains are coming on, I think that a fundamental cut in the workweek which has not occurred for a long time, and the better demographics and the job training, altogether, make the 4 percent a very realistic figure if you give about 4 or 5 years to get to it.

Representative HAWKINS. Let me follow up on that. It seems to me that those who advocate a 6- or even 7-percent unemployment base it on the fear of inflation and that automatically indicts them. What they are doing is supporting the trade-off theory that costs of wages and employment are causes of inflation. These are the same individuals who fight inflation by creating unemployment, and I think you, Mr. Eisner, indicated that they use recession as a means of dampening the economy. It is their way of fighting inflation.

Now getting away from their way of fighting inflation, which I am sure they would not even admit to, and fighting inflation in the way it should be fought based, first of all, on what are the causes of it and making a direct attempt to reach those causes, rather than indirectly through creating recessions to do it, would it not be possible with a strong anti-inflation program based on the actual causes—let us say reaching the excessive interest rates that have obviously added greatly to inflation; doing something about the very excessive expenditures on weapons that we do not even need, and the waste in the military which has been inflationary; dealing with the issue of the tax system itself which has gaping loopholes in it causing tax expenditures, and also realizing that sales and excise taxes at the local level have also added to inflation—and I could go on mentioning several other things, including administered prices, and you see now the drift toward acquisitions and mergers being encouraged by this administration, therefore reducing competition and affecting the market prices of goods and services—doing these things which are the direct causes of the inflation, rather than doing it indirectly as has been done, that is through the trade-off policy which has been discredited by most economists, at least I think publicly—even the Federal Reserve Board I think not too long ago said that it was not operative—then it would seem to me that we could then deal with a balanced-growth economy. That is, an economy which is growing vigorously as it should according to our full potential rather than restricting it as we are now, and producing the things that I think you were talking about, Mr. Eisner. The housing we need, the medical care we need, the transportation we need, the energy policies that we should have which we do not have now, and having a Federal Reserve Board with its policies compatible with a vigorous growth economy because we are no longer afraid of facing inflation by fighting it with creating unemployment and recession, could not we then proceed to reduce the percentage of unemployment that we think we need in order to achieve price stability?

Mr. EISNER. Yes, I very much agree, Mr. Hawkins, with the entire thrust of that. I perhaps have said before the situation that I think the Congress is frequently put in or the people, is like that of a doctor who has a patient who is suffering from all kinds of ills and he comes to the doctor and he says, "I want you to cure me, but now do not tell me to lose weight; do not tell me to stop smoking; and do not tell me to slow my way of life and stop drinking so much, but cure me." And that is what happens I think on the anti-inflation front.

We come in excepting all the things that contribute to inflation. I could add—I do not know how various Members of Congress react, but measures, for example, in agriculture where we repeatedly try to aid the farmer presumably, by curtailing supply, by raising prices, rather than taking measures to aid incomes, where in industry after industry with trigger prices, with quotas, with tariffs, we keep prices up—we say, "All these things we cannot touch and we cannot touch all the things you mentioned." Now how do we stop inflation?

Then Mr. Volcker or anybody else says, "Well, the only way I know to stop inflation is to damp down demand and create enough unemployment so that"—as Mr. Klein pointed out very well—"pressure in labor markets will be reduced and wages will not go up and so forth and so on."

I think that is just an intolerable situation. I think that to the extent there is any tradeoff—and I would agree that at a certain point you get demand so high that to get unemployment down you will begin to raise prices—that tradeoff can be kept at a much lower level of unemployment by taking the other measures to stop inflation which seem to be so politically unacceptable.

Representative **HAWKINS**. Do we have a tight labor market that should cause us any trouble? Do we not have a lot of slack out there of women who are not used or blacks who are not used?

Mr. **EISNER**. Sure.

Representative **HAWKINS**. Of so-called physically handicapped who are not used, and a lot of other people who are not trained that we are moving in the opposite direction, and then to conclude that we have a tight labor market and that this is a threat to inflation seems to me to be a political solution and not one that is economic in character.

Mr. **EISNER**. That is right, although I do worry——

Representative **HAWKINS**. It is because we do not want to do it.

Mr. **EISNER**. I think what is worrying me more and I sometimes fear that it is an economic solution which is apparently in the interest of some people—a loose labor market does keep wages down and in certain industries, if you can keep the demand for your product up, then you are in a very nice situation with low labor costs and high demand and you can make bigger profits. It tends to get self-defeating in the economy as a whole because, rather ironically, to any body who boosts that, recessions take a tremendous toll on profits as well as on investment and on employment.

Representative **HAMILTON**. I would like you to comment on money policy now. Should the Federal Reserve actively try to reduce interest rates at this point?

Mr. **EISNER**. I think it should. I know there is a lot of reservation on that and people say, "Well, if the Fed increases the money supply, or increases reserves which essentially is the route it would take, that that would create inflationary expectations and so forth." I really can hardly buy that and I think the lessons, despite something of an attempted counterrevolution in economics, are still fairly clear, that if you increase the money supply you can have some effect on interest rates in a downward direction, and it is only when and if inflation does result and inflationary expectations change that you would then get a turnabout. It is largely conjecture to say that at this state of the economy—an unsupported conjecture—that some further easing of monetary policy will not reduce interest rates.

I should add that I think that Mr. Klein's remarks are well taken, that if you couple this with measures, I would argue, to plan reduction of the deficit in the future, you really have a very effective double whammy and you will have a more balanced posture; you will have considerably lower interest rates.

Representative **HAMILTON**. The question, though, assuming we do not take any action to get the deficits down or if we take action that is very modest in extent, under that circumstance, should the Federal Reserve actively try to reduce interest rates; and I think your answer was, yes, you felt they should do that now.

Mr. **EISNER**. Yes.

Representative **HAMILTON**. Mr. Klein, would you comment?

Mr. **KLEIN**. Within boundaries. That is, if you would say they are subject to the same kinds of errors that we incur in studying the economy, we are asking for a fine surgical operation, I would say that we could get interest rates down by 100 or 200 basis points in the short term through Federal Reserve action without any other action——

Representative **HAMILTON**. Without an inflationary impact?

Mr. **KLEIN** [continuing]. Without a fiscal action; that would be a desirable move and, particularly, given the way that productivity is moving and other things are happening in the whole world economy, that would be an advantageous move at the present time.

If we coupled it with the fiscal actions, it could be even stronger.

Representative **HAWKINS**. In connection with that, would that also have an impact on consumer credit? It seems to me that a lot of people are spending money now. They are obligating themselves to very high interest rates and this in itself is a very negative trend in the economy today. Would you or would you not agree?

Mr. **KLEIN**. What we call the interest-sensitive components of the consumer's budget would all respond favorably. The things that are bought on credit, the durable goods, would respond favorably. Business capital formation would also respond favorably, and if American rates were to come down, it is almost certain that rates would come down around the world. We would get a better expansion worldwide which would help—it would do two things—it would help our export position and it would probably bring down the dollar in the way we want it to come down anyway. It would make the debt repayment problem somewhat easier for troubled developing countries.

Representative **HAWKINS**. Thank you.

Representative **HAMILTON**. Just one other question. You have said several times, Mr. Klein, that you support an industrial policy beyond the change in mix in the macroeconomic policy. What do you mean by the phrase "industrial policy?" What do you think we ought to do here with regard to industrial policy? Then I will ask you, Mr. Eisner, if you agree.

Mr. **KLEIN**. Well, there are some general, overall policies that should be implemented. First, there should be much more public support of R&D. There should be much more public support of basic scientific research in the civilian, as opposed to the military, sector. There should be extensive job training with emphasis on the new technologies and the new skills, particularly for older displaced workers that are in the position of changing from old skills to new skills, as well as for the young workers.

I think we should have even a better emphasis on venture capital, make it easier for venture capital to go ahead. That means doing something rather special in a further way on capital gains taxes.

I think that we should have a much more aggressive export position. I do not believe that we should go after a reduction of our "other" deficit from a merchantilist point of view, but from the view of achieving a maintainable, steady balance in international trade so as to maintain a fairly steady dollar.

I think that what the rest of the world wants most from the United States is a steady dollar, not a high dollar, not a low dollar, but a steady dollar.

Representative **Hamilton**. What do you mean by more aggressive export? You mean more subsidies?

Mr. **Klein**. No. I think the information system, the work of the Export-Import Bank, the kind of legislation we had to authorize for the establishment of trading companies, which are now just being born on the American scene, all went in that direction.

I do believe that if one would look into the history of the export program in the foreign information service in the Department of Agriculture you will find a success story of America over the last 20 or 30 years in which we really supplied the needed information and found the needed markets for our agricultural exports.

Representative **Hamilton**. Do you support this idea that was reported out of subcommittee the other day here in the House to create an industrial development bank?

Mr. **Klein**. Maybe. That is one that I have not really made up my own mind on. It is probably one of the better things.

Now I would go even further than almost all economists want to go in terms of aggressive targeting of where the growth is going to be in the future, and make sure that resources are in those sectors. This is denigrated with the expression of "picking winners."

Representative **Hamilton**. Is that credit allocation?

Mr. **Klein**. Well, that is one way, supplying resources, helping to get research started, but financing is probably the most usual.

Representative **Hamilton**. Mr. Eisner, do you want to comment generally on Mr. Klein's view on industrial policy?

Mr. **Eisner**. Yes. I agree with most of what Mr. Klein said. As I testified before the JEC hearings I guess last June, I do have some considerable reserves on some of the further reaches of industrial policy, as many people are portraying it. I am not too clear on the feasibility of picking winners and I do think, though, that most of what Mr. Klein says fits a rubric which is a good one to keep in mind. Where the private economy is likely to break down, it is important that government help along, and it will break down in several instances where we have what we call public goods where the benefits of a particular activity go beyond the rewards which are reaped by the people that indulge in it, and that applies to a very large extent to research and development, for example, which he highlighted. It applies with regard to all the measures I join in supporting to try to invest in human capital. It simply does not pay in a nonslave economy for businesses to invest in their employees, particularly the ones they do not even have.

There is also the matter of information and I think it is clear that our system does not furnish all the information necessary. Export markets may be a good example, where the lack of information in the investing in export markets is such that the government has a role to play there.

So with those broad standards of trying to minimize risks, of getting information, of providing for public goods, the government has a role and if we think of industrial policy in those terms I think there is a major role.

The reservation I have is we have to be clear that the government should not try to do things that the private market cannot do and it cannot do better. That is, if the private market does not go into something because it looks very risky and uncertain, the government had really better know that it is not risky and uncertain and a poor bet for the society as a whole. I can think of all kinds of things in the way of energy substitutes in other countries and elsewhere, of various programs, where private industry will not go in and the government says, "OK, we will make this substitute; we will develop this energy source," and it proves a bust. I think you have to be very careful that you do not become a victim of particular pressure groups that have a lot to gain and yet do not see fit to act in the market because they are not sure they have that much to gain in the free market. We have to be sure that there really is that much to be gained by society.

Representative HAMILTON. Gentlemen, we thank you both. Your testimony has been stimulating, as usual, and it is a pleasure to have you with us.

The committee is recessed.

[Whereupon, at 11:35 a.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 22, 1984.]

THE 1984 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 22, 1984

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 2358, Rayburn House Office Building, Hon. Lee H. Hamilton (vice chairman of the committee) presiding.

Present: Representatives Hamilton and Hawkins.

Also present: James K. Galbraith, deputy director; and William R. Buechner and Robert R. Davis, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

Representative **Hamilton**. The hearing will come to order.

I am very pleased to welcome to our hearing today Leon Keyserling, former chairman of the Council of Economic Advisers, and president, Conference on Economic Progress; and Mr. Gar Alperovitz, director of the National Center for Economic Alternatives.

I hope our witnesses today will analyze our current economic problems from the perspective of the Humphrey-Hawkins Act and present us with their recommendations for achieving those goals.

I understand that Mr. Alperovitz does not have a statement; Mr. Keyserling does.

Mr. Keyserling, your statement will be entered into the record in full. Since it is a long one, I would appreciate it if you would summarize it for us in a few minutes' time and then we will turn to Mr. Alperovitz for his comments.

Mr. Keyserling.

STATEMENT OF LEON H. KEYSERLING, FORMER CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS UNDER PRESIDENT TRUMAN, AND PRESIDENT, CONFERENCE ON ECONOMIC PROGRESS

Mr. **Keyserling**. Thank you, Mr. Vice Chairman and members of the committee. I recognize that the element of time requires that I do what I would have done anyway, merely summarize what I have in my prepared statement. But even in this summary, while brevity is the soul of wit, I find it hard to follow literally the suggestion I got from the chairman of the committee by letter, that I should say what I had to say in 10 minutes. It would take me 10 minutes to repeat what has just been said and what was contained in his letter as to the questions that he asked me.

But I will try to be brief.

I am very, very discouraged with American economic policy. Judge not by my sentiments, although influenced by my experience and observation, but judge by the results. During the years since the end of World War II and, more particularly, during the past 15 years, this great Nation's economic place in the world, which was always believed to be incomparable, has changed drastically. We are no longer first in per capita incomes, no longer first over a significant number of years in the rate of real economic growth, no longer first in meeting our needs to those sections of our people who have the greatest legitimate claim upon their government because of their inferior economic position. No longer first in worldwide influence because I think this is founded primarily on our domestic performance.

In view of this long, poor record, and particularly since 1966 to 1969, and its uniformity, as I shall show, and its constant repetitiveness, and its constant reassertion of policies similar in substance and philosophy, if not in degree, I must say under both Republican and Democratic administrations, I cannot limit myself, as so many economists do, to a glance at what is happening only now or only the last year or so. They impress me as the doctor who, treating a patient who has a serious fever which is recurrent over a period of 15 years, is worried when it goes up to 106°. But when it comes down to 102°, he says, everything is fine again, without looking at the future as determined by the record as to when it is very likely to be 106° again, or higher.

Now way back in 1953, just after I got out of the Government, I wrote the first of 23 book-length studies in which I forecast the policies as I then saw them and as they were likely to develop, not limited to any one administration. We would have what I called a roller-coaster performance of upturns, stagnations, and recessions. And we have had seven in a row since then, with each upturn tending to become less adequate in length and degree and each recession tending to become worse.

Now when I look at the current recovery, I find no change in this pattern. In fact, I find a worsening of the pattern. The temperature, instead of going down to 102°, or whatever figure I cited, may have gone down to 103°. And we read in the press about how we have the highest employment since when, the lowest unemployment since when. But the "since when" means the biggest recession that we have had since the Great Depression.

If you go back to any period of health as the guide to where we ought to be and ought to go, this is about the weakest recovery we have had thus far, just as the most recent recession was the worst since the Great Depression.

Now we had a rather brisk period of upturn in the second and third quarters of 1983. But, still, less in time and size than the better recoveries, though inadequate, that we had had before most of the previous recessions. Then by the fourth quarter of 1983, the record of real growth began to go down and in the first quarter of 1984, despite the more articulate cheers of satisfaction, the real rate of economic growth is sized up as being no higher than the fourth quarter.

And as a forecast for the year 1984, it is sized up to be somewhere between possibly 4 and 4.5 percent, which would not be so terrible if we were at full employment, full production. But from where we are now, it is almost 50 percent below what we did in years of good recovery.

Now this roller-coaster prosperity is shown on my first chart, and it is really amazing to see that, while, the first figures down at the bottom cross section show that a growth rate of 4 percent or better was what we did when we sustained a fairly good performance, I will skip over World War II as being extraordinary. But all the way from 1953 to 1963—well, let us take the last years first. From 1977 to 1983, we average only 1.9 percent. From 1979 to 1983, we averaged only 0.9 percent. All the way back from 1953 to 1983, we averaged only 3 percent.

In other words, the average has been very low for 30 years and increasingly worse in the most recent years. And this has cost us, and for the life of me, I cannot see how this is ignored by the economists who are talking as if they were banana sellers interested only in the day at hand. They are ignoring that, conservatively estimated, as shown on my second chart, during 1953–58 we have forfeited $15 trillion, conservatively estimated, 1982 dollars' worth of total national production—much more in 1984 dollars—or almost five times the annual rate of our current output now, as we have thrown five times that output out of the window and suffered 109 million years of unemployment above what was fairly regarded as the full employment level, which is about 3 percent, which is the way most used to think when we thought. But suppose we use 4 percent. It is not going to change that 109 million figure very much.

Now some of the later charts, which I will not go into in detail, show that most of this has been concentrated on the period since 1969, an almost $13 trillion loss in GNP measured in 1982 dollars. The greater portion of the 1953—the preponderant portion—has come since 1969.

The insouciance about this, the ignoring of it, is even more striking when we consider the effect upon sectors of the economy, upon the unemployed who have been told that they do not have what was recognized as a right, translated mostly into the realization, many, many years ago, to earn their bread by the sweat of their brow. And even that, according to Genesis, was a curse imposed for eating the apple.

And they do not consider that, according to the Government's own definition of "poverty," which decreased phenomenally during the years of reasonably high real economic growth and reasonably low unemployment, between 1953 and 1964, and that poverty figure is not shown on the charts, has increased tremendously during the more recent years.

Now it is only by looking at that long record and its import for the future, and the extraordinary likelihood that the record will be continued rather than reversed under recent and current policies, that I must discuss these policies, remembering always that there has been no great sea change in policy, certainly not since 1969.

Mostly, the same policies have been applied. They have had the same results. And the translation of those results into economic suffering and economic forfeiture, forfeiture for the whole economy, suffering for a large part of it, instead of prompting a change in these policies, seems to have, in the eyes of the policymakers, vindicated them and called for more of the same.

Now I am not going to talk about any derelictions on the part of the Congress. That would be an act of—what shall I call it, on my part—in testifying before this congressional committee. The Congress, to be sure, has not done itself proud. But the real reason that I am concentrating upon the policies of the administration is that that is the subject of my testimony in being asked to concentrate upon the Economic Report of the President and the Report of the Council of Economic Advisers.

Now, what is the first of the great errors, by now enduring, still present, and projected into the future?

The first of the great errors is that the makers of policy and those advising them have forgotten what the chief purpose of an economy is and what is the chief test of its performance.

I do not see how anybody in the American tradition, or anybody with common sense, from Russia to the United States and every place in between, can doubt that the chief purpose of economic policy, the only ultimate purpose, is to increase and to optimize the real output of goods and services, to increase the real GNP, and to distribute it in a way which meets the requirements of economic balance, leading to a sustaining of the good performance, and meets reasonably our great national priorities, to which the Federal Government turns attention, and what we call economic or social justice.

But you would hardly think from reading the Economic Report of the President and the Report of the Council of Economic Advisers, and the assertions of the economists who advise them, even though some of them may attempt to gain academic kudos at times by differing publicly with the President they serve, for which they ought to be properly fired, regardless of who is right and who is wrong. But in the main, the top economic adviser, the main manufacturer of the Economic Report of the President, and far too many of our distinguished economists, pay relatively little attention to the fact that it is production and distribution of goods and services that takes care of everything—everything—that we want and need economically. This is what takes care of them, for better or for worse, that is, what supports national defense and vacations and food, clothing, shelter, and anything of a material nature you can think of. They are all furnished and supplied with the flow of goods and services.

But the tremendous deficiencies in these are neglected, while the top priority action is directed toward things in the economy of very little import at all, except insofar as they add to or detract from in the short run and the long run this fundamental purpose of producing and using goods and services.

On the subject of inflation or price stability, our history shows, and I do not have time to cover it in detail, that you can have reasonably full employment and production, which are the core objectives, with a stable or a falling or a rising price level. Prices are but an instrumental factor. Theoretically, if incomes all increased in the same proportion to prices, which they do not, the changes in prices would be of negligible significance.

But at times, the restraint of price inflation appears to be almost the sole priority of national economic policy and given far higher precedence than the real flow of goods and services out of the cornucopia of the American economy, which should always come first.

The same thing is done regarding the Federal budget deficit.

To illustrate the retrogression in national economic thinking, conservative and liberal, several decades ago, and I am not resurrecting a dead past but citing a warning experience, Republican and Democratic economists, elected leaders, and almost everybody in between said the reason that we have had recessions, but not depressions, since the Great Depression, while we had real depressions every 7 years or so before the Great Depression, the real reason was that we had the so-called automatic stabilizers enacted in the 1930's of a permanent nature.

And the most important of these, not entirely automatic, but in part the result of national policies, the most important of the stabilizers, according to the thoughts of most of them, was that the Federal Government ran a deficit when the economy was in deep trouble in terms of production and employment, and that this helped to support the economy and bring us out. And I think hardly any economist would deny today that if, by some combination of bigger tax increases instead of incontinent tax reductions, and even crueller slashes in public spending of a Federal nature, we had sought to avoid the recent deficit, which, incidentally, is only 8 percent, or between 6 and 8 percent, of a $3⅓ billion economy, much less than it was at some previous times when we did very well—if we had sought to avoid the deficit and had been moderately successful, we would have had another one or more real depressions instead of recessions.

But what a sea change there has been in economic policy and economic thinking, not to make the Federal Budget and the deficit the handmaiden of economic performance, but to make it of supreme importance regardless of the economic performance. And to talk about steep increases in taxes and to actualize steep decreases in some of the most important Federal programs in order to try to get rid of the deficit, no matter what it does to the economy, and to the detriment of the economy; and to social programs.

Now, that is what is going on, and there is a perverse irony about it that almost makes one feel that there is some supreme power who is giving us what we deserve, because the effort to reduce the inflation by slowing down the economy and the tradeoff, and the effort to hold back domestic spending in the budget, has given us bigger deficits than we have ever had, except during World War II.

I cannot be turned away from that by what has happened in a few months of one year, which is easy to explain as an undulation within the general pattern. But, chronically, during the last 15 years or so, we have never had such rises in prices, caused not by an excessive real economic performance in the things that count most, but by the deficiencies which reduce productivity and raise costs and so forth and so on. And we have had a cruel and large and growing increase in the deficit by striking the same blows at the economic performance.

My charts demonstrate all of this and the increase in the deficit has not been due primarily to too little taxes or too much spending; it has been due primarily to the fact that you cannot squeeze the blood of adequate Federal revenues from the turnip of a starved economy, from a stunted economy. That is where the deficit comes from. And that is why it is going to grow inexorably in the years ahead, even in the views of the astigmatic economists who talk about it, no matter what the President says and no matter what the Congress says and no matter what they do, if what they do is anywhere near in accord with recent and current policies.

So we have the worst of all worlds by policy design—a stunted economy, insufferable unemployment, chronic inflation, the biggest ever in modern times, Federal deficits rising as they never rose before, and all interacting and having the same effects.

Now, in the effort to extenuate, if not justify, mind you, I am not for deficits. It just happens that during the 7 years when I was Chairman of President Truman's Council of Economic Advisers, and to the credit of President Truman having more influence than any chief economist since because there has never been one—there have only been two or three, contending with each other. We ran during the 7 years, 1946–53, despite the costs of the Korean war, an average annual surplus of $1.7 billion in the Federal budget. And not by neglecting other vital needs. And we averaged a price inflation of 3 percent, getting down to 0.8 percent in the last year and unemployment of 4 percent getting down to 2.9 percent in the last year.

That is the record. And saying that it is old hat and that we need something newfangled, regardless of experience, which, incidentally, is corroborated by all the experience of the 30 years since. Saying that does not recognize that in all human activity, experience is important, although it is not all controlling, especially when you analyze it correctly and bring it up to date.

Now on the tax policy, what have we done? The examination of the periods, and this, incidentally, you will not find in any of the economic reports for many years, or this year, or among the economists more generally—a real examination of why this has been happening to us. You hear some mouthings about what the Federal Reserve Board has done, and so forth and so on, but you do not find any examination of the facts, as shown by my charts. And, incidentally, I have never had the experience of having anyone challenge my facts, or really attempt articulately to challenge the conclusions, or almost whatever else we have arrived at.

You find that the real explanation of the descent from advance to stagnation to retreat—now this sounds old fashioned, but it is true—that in every period of advance, the rate of real growth in the business investment that increases the ability to produce has outrun two or six times the advance in ultimate demand represented both by consumer spending and Government spending.

And as these discrepancies become more extreme, business investment has been cut back for lack of markets, and this, together with the more enduring and larger deficiencies in ultimate demand, composed of both private spending and public spending, have brought on the recessions.

This is the unvarnished record all the way through. And I am most worried now, as shown by one of my charts on this subject, that in this period of so-called recovery, the real rate of investment in plant and equipment is moving several times as fast as the real rate of advance in consumer spending plus public spending. And all the euphemistic conclusions about consumer spending holding up the boom measures consumer spending against where it was during the recession, but not against where it ought to, any examination of past economic balance brought up to date, or any analysis. And it is overlooked. Despite the virtual frenzy about the size of the Federal deficit, it is overlooked that as to consumer spending among the middle and lower income groups, which is where it counts most because they spend the larger part of their income, there is a sharp drawing down of savings and, most dangerous of all, as shown by one of the charts, a tremendous increase in the ratio of their borrowings to their disposable incomes. They are borrowing themselves to the choking point, and at interest rates which you would not have dreamed of when our policies were in accord with good sense.

I do not see how anybody can deny that this kind of increase in the consumer debt burden is more serious and less manageable than the increase in the Federal deficit. But who talks about it? Even though when looking back to the experience before the great crash, you see the high relevance of this, when nobody could pay what they owed any more and the Government had to take almost all of it over temporarily, which I hope never happens again.

But despite this obvious problem which, as I have said, is moving very fast even now, what has tax policy done? I have five or six charts, all of which show that the tax policy has allocated enormously more, in ratio to the relative magnitudes, to attempts to stimulate investment, while, in fact, the tax burden upon the disposable incomes of those from the middle down has been greatly increased. It has become more and more distorted.

This was also true in 1964 with the tax reductions then which have provided the advertising medium for repeating the performance since, only worse, although by 1966, these distorted tax reductions began to show their evil effects.

The tax reductions of 1981 were so distorted between investment and consumption, and among consumers depending upon their place in the income scale, that I do not even bother to show that on the chart. Everyone has been talking about it. And what have the results been? Those 1981 tax cuts did nothing to stimulate business investment because they did not need funds. They needed markets. And the markets, as I have shown, were not there in adequate amounts.

Coming over from tax policy to money policy, the monstrosity of monstrosities, ever since 1951–52, when the accord between the Federal Reserve Board and the Treasury occurred, President Truman had the feeling that if the Government sold somebody a bond for $100, they ought to be able to cash it in for $100 at any time, that the Government should not treat lenders worse than a private borrower if he were not bankrupt. To be sure, he had to recognize that if inflation went up, that the $100 would be worth less, but at least they got the $100.

When the Federal Reserve withdrew its support from Government bonds, bonds became more speculative than stocks. And interest rates soared and the interest rates, probably as much as the tax policy, have fantastically distorted the distribution of income, placed an interest burden upon the Treasury, which explains a very large part of the deficit, and served no useful purpose.

But what do we now hear? We hear that, starting with the proposition that the deficit should be brought down, the main reason for which is not that it is not stimulative under current conditions. And there is no observation of the fact that I show that, by meeting reasonably, fully, our national needs, the budget could be brought into balance within the 5-year ambit of the Humphrey-Hawkins Act by getting back to 4-percent unemployment and proper GNP. We would have a balanced budget.

Nobody is even doing that exercise.

But the deficit is so big now because the economy is operating so badly. The argument for reducing the deficit is not that you need—in fact, the economists say that we do not need to get it down right away; we need to get it down later. But how? But then they say, we have to get it down right away because that is the only way of getting interest rates lower and that is the only way of not causing private capital borrowing to be crowded out.

Well, this is the damnedest nonsense—excuse me—I have ever heard. Private investment is not being crowded out by lack of borrowable funds or interest rates. The interest rate can shift to the consumer and they have plenty of funds. The investment is being crowded out by lack of demand.

But, anyway, even if this were not so, the very statement that private borrowing is crowded out by public borrowing neglects the fact that this is the consequence of the policies of the Federal Reserve Board, which can and should provide an adequate growth in the money supply to take care of both. When it does not do so, it is not by any ineluctable law of economics or any relationship between public borrowing, on one side, and private borrowing, on the other side. It is due to the economic and social philosophy of Mr. Volcker that a big deficit at any time is a bad thing, that adequately meeting domestic human, economic, and social needs is not necessary now, that high unemployment is unfortunate but it should not be put first, and therefore, his imposing upon the executive branch and, really, upon the Congress, the responsibility to follow a fiscal policy in accord with his czaristic demands.

It is, therefore, the duty of the administration and the Congress to change, by statutory definition if necessary, the functioning of the Federal Reserve Board. Federal Reserve policies were changed very successfully in the 1930's when interest rates were brought down enormously—I mean beginning with 1933. Although they had been very high during the recession, I have not time to go into that.

So it is Mr. Volcker that is supporting the veritable canard that interest rates cannot be brought down until the deficit is lowered and that, therefore, deficit reduction must be given the first preference, and this attempted in a way which, in fact, is going to increase the deficit.

So it is not merely a matter of differing views as to the consequences of current economic policies. It is a matter of blindness to what had been proved now for a long time to be the results of economic policies.

So we can see the erroneous policy on money and on taxation and, likewise, on spending. It is perfectly obvious, or should be, that the first purpose of the Federal budget is not to stabilize the economy, although that may be a worthy, secondary purpose. The first purpose of the budget is not to balance the budget. You could do that by having no budget.

The first purpose of the budget is to meet those national needs through spending or investment which cannot otherwise be met. In accord with the philosophy of Abraham Lincoln, "it is the responsibility of Government to do for the people what they need to have done and cannot do for themselves or cannot do so well in their separate and individual capacities."

This is completely ignored. My charts show what has been happening to the Federal budget in real terms, especially with respect to the most vital programs, and the prevalent but wrong attitude toward unemployment and the attitude toward those programs is that economically, morally, socially, and humanly the first people to be made to suffer when we are in trouble is those of the middle income and lower down, while those in the top are battened and fattened by the very policies which are causing these results.

This is not an extreme statement; it is proved by the entire record. So the whole policy is upside down and this, very briefly, is what my charts show.

Incidentally, all of my recommendations are based upon doing what the Humphrey-Hawkins Act calls for, instead of ignoring it in a manner unequaled by a President—I will not talk about the Congress—in the history of the 20th century. You pass a law after 4 years of hearings and debate by a majority of more than 100 in the House, as I recall it—details do not matter—and 6 to 1 in the Senate. And then you start ignoring it, not after you find it does not work, but without even getting it started.

President Carter's last Economic Report deliberately sought to increase unemployment and deliberately to court a recession.

Representative HAMILTON. Mr. Keyserling, your 10 minutes has stretched to 40 and we are going to have to ask you to wrap up your statement, as good as it is, so that our other witness may have an opportunity to testify as well.

Mr. KEYSERLING. Well, I am about through with my statement.

Representative HAMILTON. All right, sir.

Mr. KEYSERLING. In fact, I can conclude it at this point. My recommendations are in accord with the Humphrey-Hawkins Act and, if there were no Humphrey-Hawkins Act, in accord with what is needed and what was done during World War II and during every other period when the economy did well—on employment, unemployment, production, inflation, budget balance, and so forth.

And my conclusions and recommendations as to the budget are based upon the idea that the budget is not a brooding omnipresence in the sky, but a part of the functioning economy. My charts show what should be done. They call for no big tax increases because the economy is where it is. They call for large, but entirely manageable, increases in domestic spending, with some decreases in the military and substantial increases in the vital domestic programs. And they call for the Congress taking a hand in the basic policies of the Federal Reserve.

Thank you very much.

[The prepared statement of Mr. Keyserling, together with the charts referred to, follows:]

PREPARED STATEMENT OF LEON H. KEYSERLING*

Mr. Chairman and members of the Committee:

We are putting first things last and secondary things first, with great damage to both

The prevalent and predominant concentration upon the very recent and current economic situation, and upon the economic outlook stemming therefrom, leads to gross inadequacies of analysis, accompanied inevitably by basically wrong national economic policies. Rome was not built in a day, and the unrivaled American economy cannot be viewed nor treated intelligently without primary focus upon longer-range performance and policies. Examination of these reveals clearly what has been and still is going wrong, and that substantially the same national policy errors which account for the dismally inadequate economic performance in the longer-run explain the trouble today and the discouraging outlook when viewed realistically and not through rose tinted glasses.

The longer-range examination which I am presenting is based upon the unassailable but sorely ignored proposition that the ultimate and central objective of economic performance is to achieve and maintain an optimum real rate of growth in the production and distribution of goods and services, compatible with reasonably full employment and full production, attention to our great national priorities, and the improvement of economic justice. After all, everything that we do economically as a nation is supported by production and distribution of goods and services, from national defense activities to all domestic endeavors. A rising standard of living equitably shared is also based upon this production and distribution. Instead of concentrating upon this towering central purpose, national policies especially since *circa* 1969, under both Republican and Democratic Administrations, have subordinated these central purposes and in part deliberately worked against them, in the unsuccessful effort to deal with the size of the Federal deficit, the trends in prices, and various aspects of our international economic relationships. These last matters are important. But a higher or lower Federal deficit, a falling or stable or rising price level, and our balance of trade and payments positions, are all to be evaluated as mere *instruments* toward the optimum production of goods and services through an adequate rate of real economic growth accompanied by how these are distributed in accord with priorities and equity. To give policy supremacy to the instrumental factors, while subordinating or affirmatively impeding our ultimate economic purposes as I have defined them, puts the cart before the horse. In addition, it ironically and seriously augments *chronically* instead of alleviating the troubles even as to these aspects.

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* President, Conference on Economic Progress. Chairman, Council of Economic Advisers under President Truman.

Our lamentably deficient economic performance during many years, and some of its main consequences at home and overseas

As shown by my Chart 1, the average annual real economic growth rate required to meet our central economic purposes during certain periods in the past indicates a needed average annual growth rate ranging between 4.5 and 5 percent when we were near full use of our human and inanimate resources. But this real growth rate averaged only 3.0 percent during 1953-1983, only 3.2 percent during 1966-1969, only 2.5 percent during 1969-1983, only 1.9 percent during 1977-1983, and only 0.9 percent during 1979-1983. As shown by my Charts 2 and 3, these departures from a reasonably full economy have caused us to forfeit 15 trillion 1982 dollars worth of GNP and about 105 million years of employment opportunity during 1953-1983. The concentration of these forfeitures has been during 1969-1983, meaning 12.6 trillion 1982 dollars worth of GNP and close to 67 million years of employment opportunity.

As shown by my Chart 4, total unemployment rose chronically from 4.5 million in 1965 to 9.6 million in 1983. In economic and human terms, this is the most serious and dangerous thing that has been happening to us, compounded by the immense differences in the unemployment rate between whites and those among blacks and others as shown on the same chart. Other effects have been poverty and deprivation among scores of millions of others, with those in poverty rising greatly in numbers and percentage since 1966, contrasted with vivid reductions during earlier years when the economic performance record and the national policies contributing to it achieved much better results. As shown by my Chart 5, other adverse consequences have been the great adverse impact of the increasingly deficient economic performance upon productivity growth and, as shown by my Chart 6, measuring over a sufficient number of years to be meaningful, the superior real economic growth rate of many other countries compared with our own. This has been damaging to us in many ways, including but not limited to placing us at a competitive disadvantage and aggravating our balance of payments and trade difficulties.

Highly unsatisfactory content of the current "recovery"

The improvement in our economic situation during 1983 and on into 1984 is to be welcomed, but it is dangerously exaggerated and leads to unwarranted complacency. Viewed realistically, it is a much weaker improvement than was registered after most of the earlier recessions. It bespeaks in fact a continuation of the roller coaster economic performance since 1953, and especially since 1966, when during a succession of stagnations, recessions, and inadequate upturns, most recessions have tended to become more severe and each recovery briefer and less satisfactory. Developments by the fourth quarter of 1983 and on into 1984 bring strong confirmation of these earlier trends, which means that we should concentrate upon averting the strong current prospect of more of the same and still another recession within a year or so, instead of getting enthusiastic about the totally inadequate improvements registered since the most recent recession. I shall say more about this as I proceed.

Appropriate goals for the years ahead, as guides to needed policy readjustments

Instead of letting nature take its course or preening ourselves about what is now going on, we should, in accord with past experience and current needs and common sense, set performance goals for the future and make strenuous but entirely feasible attempts to reach them. My Chart 7 depicts what the overall goals and their main components should be, and contrasts these with my estimates of the results of current national policies. These results are in some respects reasonably in accord with the CEA's economic assumptions as set forth on p. 197 of the 1984 CEA Report, and my variations, especially as to unemployment, are due to the fact that the Administration's economic assumptions have thus far been proved to be much too optimistic. As my Chart 8 indicates, the spread during 1984-1988 between achievement of the needed goals and the continuation of current national policies means a difference of more than 1.36 trillion 1982 dollars worth of GNP and more than 16 million years of employment opportunity. The GNP difference would be increased greatly by translation into 1984 dollars. I use the end year 1988 because it represents the five-year Humphrey-Hawkins timetable, starting with 1984.

The central cause of the long-term roller coaster: investment outruns ultimate demand in the longer-term

The central feature which explains the long-term roller coaster performance, in the past and even now, as shown on my Chart 9, is the tendency of investment in plant and equipment, which increases our ability to produce, to grow in real terms very much more rapidly than ultimate demand, in the form of consumer outlays plus total public outlays for goods and services during the "boom" periods. The comparisons are all in uniform dollars. This has led in due course to cutbacks in investment growth which, along with the larger and longer deficiencies in ultimate demand, have brought on the recession periods when such investment, being the more volatile sector, has been percentagewise more adversely affected than ultimate demand. As shown by the same chart, the trends in corporate profits compared with wages and salaries as the main factor in consumer demand have been such as to support the imbalances between investment and ultimate demand, even though profits being relatively more volatile went down much more than wages and salaries during the recession periods. To illustrate most recently and very pertinently, from 4th qtr. 1982 to 4th qtr. 1983, investment in plant and equipment in real terms grew 7.3 percent or more than twice as fast as the 3.6 percent growth rate in ultimate demand. Profits grew 35.4 percent and wages and salaries only 4.0 percent. Further on this same subject, my Chart 10 indicates that the deficiencies in wages and salaries have been a dominant element in the deficiencies in total consumer incomes before taxes. Profit growth during this "recovery" period has been high relative to other sectors. My Chart 11 shows the extent to which the average annual real increases in wages and salaries have lagged behind productivity gains. And my Chart 12 shows the extraordinary rise in consumer debt and credit in ratio to disposable income is further affected by rising interest rates. This increasing burden upon consumers is really much more serious than the national debt or the Federal deficits contributing to it, and explains why the deficiency in consumer spending has not yet been even larger and had an even more serious effect upon the economy than it actually has exerted. Yet very little attention is paid to this problem. Indeed, as I shall later show, the CEA 1984 Report is much more bearish in its forecasts for consumer spending than in most of its other forecasts.

We do hear on many sides that "ebullient" consumer income trends have done much to support the current recovery. To be sure, during the most recent recession, consumer spending did not perform as adversely as business investment, and this has also been true during the "recovery" movement. But the lag in investment during the "recovery" movement, despite the huge tax concessions of 1981, demonstrates that, measured in terms of relative magnitudes, the lag in ultimate demand through the deficiencies in consumer spending and public outlays has been much more causative and in more need of immediate remedy than the lag in business investment

To put this in another way, a *sine qua non* for adequate economic analysis and remedial action is to make a long-range as well as a short-range appraisal of the *balanced* requirements for a better economic performance, which means the relative stress to be placed upon trying to stimulate business investment directly and stimulating it through more adequate ultimate demand. Instead, this apportionment effort is being made on purely ideological grounds and preferences rather than upon even attempted appraisal of realistic adjustments. This approach is in complete violation of many of the main points of emphasis in the Humphrey-Hawkins legislation, an emphasis which, independent of that legislation, was always resorted to when we did so well economically during World War II and in some later periods of relative peacetime. To put these conclusions in a capsule, *the Government has become a great instrumentality for distributing income upward, which grossly violates the requirements for economic progress conventionally defined and the requirements for serving social and human needs*.

An excellent example of the upside down approach has been and still is the treatment of Federal spending through the Federal Budget

Instead of elevating the size of Federal spending absolutely and in ratio to GNP in order to stimulate the economy sufficiently, the total Federal Budget as shown by *Chart 13* has been and is being systematically reduced in ratio to GNP, especially as to high priority domestic and people-oriented programs, with corresponding damage to the economy at large and to our great national priorities and the human well-being of those in the lower portions of the income structure and many of those in the middle as well. The same chart, carrying through fiscal 1985 in the case of the President's Budget and through calendar 1988 in terms of appropriate goals, contrasts actual budgets and the President's projections with the needed goals through 1988 in accord with the timetable under the Full Employment and Balanced Growth Act. Specifically, comparing fiscal 1985 with fiscal 1984, the President's Budget (in fiscal 1984 dollars) increases total federal outlays by 35.2 billion, and increases only nominally from 23.73 percent to 23.79 percent of the President's estimated GNP. Meanwhile, the national defense etc category is increased 18.1 billion, or from 7.46 percent to 7.69 percent of GNP, while the domestic programs are increased by 17.1 billion or decreased from ~~[illegible]~~ 16.27 percent to 16.12 percent of GNP. As the chart shows, there are utterly noxious

much larger

cuts in some categories of domestic outlays.* In vivid contrast, to help achieve the goals of the Full Employment and Balanced Growth Act of 1978 as I have already stated them, the goals for fiscal 1985, as compared with the President's proposals for 1985, are to increase total federal outlays by 42.7 billion, or to decrease them from 23.79 percent to 23.18 percent of a very much larger GNP as stimulated by my suggested changes in other policies, to decrease the defense etc. category by 13.0 billion, or from 7.69 percent to 7.10 percent of GNP, and to increase domestic outlays by 55.7 billion, or from 16.12 percent to 17.09 percent of ~~the~~ ~~larger~~ GNP. As I show elsewhere in my discussion, this is also the way to achieve the secondary purposes of balance in the Budget rather than to run increasing deficits, and to achieve price stability instead of chronically rising inflation.

Misplaced worry and action regarding the Federal deficit

The entirely upside down performance in terms of needs and capabilities is based in large measure upon obsessionary preoccupation instead of legitimate concern about the size of the Federal deficit. But as earlier indicated, the size of the deficit is infinitely less important than the performance of an economy which has been struck hammer blows by a repressive budget in terms of need. And ironically, the deficit has soared and is bound to grow further if recent and current policies continue, because the blood of adequate Federal revenues cannot be squeezed from the turnip of a stunted economy. In contrast, national policies geared to reasonably full employment and production, in accord with the goals and timetables of Humphrey-Hawkins, would balance the Federal Budget by calendar 1988. This is demonstrated by my Charts 14 and 15, the last of which shows the vividly contrasting results of desirable policies and current national policies as projected. To cap the climax, my Chart 16 indicates that, while the ~~aggregate~~ average annual difference during 1984-1988 in Federal Budget outlays between the two policy approaches is estimated at 53.8 billion 1984 dollars, the ~~aggregate~~ average annual difference in GNP ~~aggregate~~ is estimated at 257.8 billion. It is hard to imagine a better bargain, but we are obstinately and in defiance of a wealth of past and current empirical evidence continuing to move or attempting to move in the opposite direction.

All of this represents a sorry retrogression in economic thought and action, not only among public officials but also among so many of the leading economists. Beginning several decades ago, there was a pronounced consensus that the reasons why the downturns of depressionary magnitude which were recurrent even before the Great Depression were succeeded after World War II by holding these downturns to only recessionary magnitudes because o the so-called "built in stabilizers." One of the most important if not the most important of these was the willingness to allow and even encourage growing Federal deficits to compensate for unfavorable trends elsewhere in the economy. Conservatives joined with liberals in this position. The diametrical reversal of position recently and today is hard to understand and almost impossible to justify. If, despite the wails of protest, the deficit had not been permitted to increase as it has in the face of and due to stagnations and recessions, in other words if tax increases and even larger spending cuts had sought to avoid such large deficits under these circumstances, we very likely would have experienced another depression instead of the recessions which have recurrently been our lot. Nor is notice taken that a 200 billion dollar deficit is only about 6 percent of a more than 3.3 trillion dollar economy and contributory to real growth though inadequate, while there

Another problem. I cannot understand the CEA figure of 18.3 for domestic compared with my 17.3 for domestic.

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* The ~~discrepancy~~ difference between the 7.46 figure for national defense and the 6.7 figure shown ~~as~~ on the CEA Report p. 29 is probably due the higher figure including the entire defense etc. category while the lower figure probably includes only defense.

were times such as World War II when a deficit infinitely greater relative to the size of the economy was welcomed and proved beneficial in the long-run as well as the short-run, and was overcome in time with the help of high real economic growth. This should not be taken to mean that I favor deficits per se. During my seven years on the CEA under President Truman, we registered for the last time to date an average Federal surplus despite the costs of the Korean war by meeting rather than neglecting economic and financial common sense. This is demonstrated by my Chart 29.

Upside down long-term action on the tax side of the Federal Budget, regressively inimical to the economy and the people

Beginning with 1964, and accelerating in later years until the peak was reached in early 1981, we have come to look upon juggling up and down of the tax structure as the main road to economic improvement. This is not true for a variety of reasons, one of the most important of which is that Congressional tax changes are too "controversial" to be handled with equanimity rather than in response to self-serving interest group pressures. A good formulation is that it is "easier" for the Federal Government to reduce taxes than to do anything else; but timid pursuit of the easiest course is no substitute for the courage of righteous action. The empirical evidence is clear that variations in Federal spending are far more suited to serving the economy and priority needs, and far more efficient in terms of costs related to accomplishment. My Charts 17, 18, 19, and 20 indicate from 1964 through 1979 the perverse effects of the recurrent tax cutting, allocating far too much to the investment function and far too little to the consumption function in terms of economic balance, and treating the changes in the personal tax structure very regressively. The perverse nature of the 1981 tax cuts is too well recognized by now to necessitate precise description here, except to say that the failure of these tax cuts to stimulate investment has been the latest indication of why investors need more demand for their products rather than more funds. And my Chart 21 shows for 1968, the latest data available to me, the uttter maldistribution of the nationwide tax burden when all types of taxes are not taken into account. Undoubtedly, the maldistribution is very much worse now.

The increasingly erroneous national housing policy and its hurtful consequences

Another growing deficiency in the economic situation and outlook is the trend in housing starts. As shown by my Chart 22, only once since 1972 have housing starts come close to the number in that year, and by fourth quarter 1983 the declining starts, temporarily reversed but not enough in early 1984 was an augury of why the general economic slowdown is likely to increase and move over into another recession somewhere in the neighborhood of a year or so. To correct this situation requires far more Federal spending in aid of some housing for low and middle income groups, and my Chart 13 shows that the Federal Budget is moving dangerously in the opposite direction. To round out the housing picture, my Chart 23 demonstrates that current interest rates on home mortgages are about two and a half times as high as would be needed to generate an adequate volume of housing starts, with concentration upon middle and low income families.

The iniquity and inequity of Federal Reserve Board policies since 1951-1952

This brings me to the monstrosity of monstrosities, the policies of the Federal Reserve Board and System. The current moaning and groaning about "excessive increases" in the money supply do not adjust for inflation, even though it is palpable that it is the real growth rate in the money supply and not the *nominal* growth rate which determines whether the growth is adequate to support the economy at adequate levels of performance. As shown by my *Chart 24*, the *real* average annual growth rate in the money supply averaged zero between 1955 and 1983, averaged seriously negative in many years thereafter including 1973-1975, averaged *negative* 4.9 percent during 1978-1980, and averaged up only 1.7 percent during 1980-1983. It is too generally recognized for me to illustrate it further that the erratic nature of the growth in the money supply and its inadequate expansion in real terms has done much to explain the stagnations and recessions in the roller coaster economic performance, as shown also by the same *Chart 24*. More commonly recognized, although nothing substantially is done about it, are the devastating results of increases in average interest rates. My *Charts 25 through 28* demonstrate from 1952 to 1982 the fantastic excesses in interest rates and their costs, the veritable robbery of the Federal Budget to no good purpose in ratio to the inadequate magnitudes of high priority programs, the soaring ratio of total interest costs and excess interest costs to gross national product, and how the Federal Reserve Banks have profited by soaring interest rates at the expense of those plundered by these exorbitant rates. After allowing for inflation, real interest rates are still at peak levels.

Most meretricious of all arguments is the claim that, while interest rates admittedly must be reduced greatly to enlarge economic growth and bring us closer to reasonably full resource use, it is also claimed that interest rates cannot be reduced until the deficit is first reduced greatly. This is on the alleged ground that the current size of the deficit "crowds out" private borrowing for investment, necessitates the exorbitant interest rates, and thus impedes adequate recovery. The fact is, as I have already shown, that very large private investors are not impeded by the high cost of money, which they in any event shift to the consumer, but rather by lack of ultimate demand which also militates against national economic policies in general. And the rate of interest historically has correlated neither with the size of the deficit nor has the size of the deficit correlated with any alleged "crowding out." World War II is probably the best example of a swiftly rising deficit, combined with unparalleled real growth in the economy, price stability, and maintenance of low interest rates. There have been other examples in more recent years. *Federal Reserve policy can and should properly adjust the real growth in the money supply and the rate of interest to economic performance needs and economic fairness,* For reasons already stated, this will help mightily to reduce the deficit. independently of the size of the Federal deficit./ The failure to do so resides primarily in Mr. Volcker, who is translating a reactionary and outmoded attitude toward deficits and toward Federal spending for domestic purposes into his demand that he will not correctly adjust /Federal Reserve policy until the President and the Congress continue to bow to him as the self-appointed czar of national economic policy in its entirety. The Congress, with or without initiation by the President, should by appropriate standards for monetary policy, /put an end to a situation where the Federal Reserve is the virtual dictator / of national economic policies, answerable in actuality to none to a degree enjoyed by no other instrumentality of our national government.

A careful reading of the February 7, 1984 /FRB Board of Governors Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978 reveals impressively that Mr. Volcker's views are about as I have expressed them. There is no sense whatsoever that the Full Employment and Balanced Growth Act of 1978 practically mandates the "Fed" to support what I have designated as the towering central purpose to help promote the optimum real growth of the economy and the steady reduction in unemployment in terms of that Act. This is not only a signal violation of greatly needed policies; it is also in accord with the practically universal flaunting of that Act itself.

The upside down and failed attempt to restrain inflation

Now I come to the matter of inflation versus price stability, a subject I have discussed so often since 1953 before this Committee and elsewhere that I need not elaborate upon it again. My Charts 29 and 30 present the empirical evidence in the longer run /of positive rather than inverse correlation between low unemployment and price moderation, and vice versa. This long range experience is not negated by the strong decline in price inflation during 1953 as a whole, for that was occasioned by at least the temporary nonexistence of factors explaining the double digit inflation in some earlier years. The underlying rate of inflation, as against that affected by temporary and unexpected factors, /has been increasing again since late 1983 and is now two to six times as high as it was during various periods /when the economy was in reasonably full use. The best thing to do now would be to stop using the rate of inflation as an excuse for all of the wayward national policies which I have mentioned, and to start recognizing that the full restoration of a healthy economy would be worth more than any marginal differences in the price level, plus the fact that this course is the surest and safest way toward price stability.

Toward a meaningful national incomes policy

Beyond the erroneous application of the "trade-off" between inflation and unemployment, I have already pointed out that a good or a poor basic economic performance in terms of production, employment, and unemployment can result and has resulted during falling or stable or rising prices. The crucial issue is whether the relationships among prices and incomes are conducive to or inimical to the basic economic performance by being balanced.

Thus, it has been unanalytic and defective to use controls or guidelines as they have been used since the 1960's in an ineffectual attempt to stabilize prices and an effectual effort to restrain real wages excessively, in a manner which works against economic balance, the balance being a sustainable relationship between real investment and real consumption. Instead, a successful national incomes policy should, as it has not during the 1960's to date, deal with prices and incomes in a manner designed to achieve and maintain this balance. As this depends so largely upon income flows, all national policies should be attuned to this balance by means of what I have called a nation's economic budget developed by the Council of Economic Advisers. This necessarily includes national taxation, spending, and monetary policies, both macroeconomic and microeconomic. As I have shown, these policies have been used in a perverse or upside down fashion. When used properly, the economy worked very well.

The erroneous and shabby content of the 1984 President's Economic Report and that of the CEA

In sharp contrast with these imperatively and immediately needed shifts in national economic policies, we now have before us the 1984 Economic Report of the President and the comprehensive CEA Report transmitted with it. These plus many of the independent pronouncements of CEA Chairman Martin Feldstein in support of the President's policies, are as fine an example as one could discover of being demonstrably wrong on almost everything—wrong in terms of long experience, and wrong in terms of the revealed results of these policies which are really modeled after the mistakes of many previous years.

The appalling and all-pervasive defect in the 1984 Economic Report of the President and the accompanying Annual Report of the Council of Economic Advisers is that they put things upside down by concentrating upon the secondary, derivative, and instrumental aspects of the situation, to the gross neglect of those problems which, as I have said, are of towering and central significance.. The economic functions of the President and the Council of Economic Advisers are defined by the seminal Employment Act of 1946, set forth as maximum employment, production, and purchasing power. But these subjects are subordinated, and dealt with both ineffectively and erroneously. These errors of commission and omission are glaringly accentuated, as I shall show in due course, by virtual neglect of the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. One would think, from studying the official documents which I am discussing, that the level of unemployment, rising chronically for many years and still indefensibly high and insufficiently reduced, as well as the tremendous gap between actual and potentially needed GNP, are not lodged strongly in the minds and hearts, much less the actions, of the policy makers in the Executive Branch, beginning but not ending with the President of the United States.

The content of these documents, in coverage and emphasis, demonstrates obsessionary preoccupation with secondary and derivative matters, significant though they are. To illustrate, the discussions of industrial policy, food and agriculture, and financial market deregulation dominate the documents. And what these discussions say/ in detail is flavored and weakened by the wrongful general economic analysis and policy which are also the main reasons for the difficulties in the areas upon which relatively excessive attention is focused. The chapter on industrial policy contains a discussion of our unemployment problem which is cursory, shallow, and overly optimistic. This is accompanied by a discussion of Japanese industrial policy and European industrial policies, designed to indulge in criticisms not borne out by the superiority of their economic performance to ours in the longer run, as shown by my Chart 31, and being guided by an effort to/ prove meretriciously that our current national economic policies and the analysis underlying them are highly to be praised instead of drastically changed.

The discussions of Federal Budget spending on pp. 29 through 31 of the CEA's Annual Report are even more disturbing. Contrary to the needs which I have set forth above, Table 1-1 at the top of p. 29, setting forth Budget outlays and GNP, indicates total outlays falling from 24.7 percent in fiscal 1983 to 24.0 percent in 1984 ~~(evidently rounded down)~~ to 23.4 percent by 1988 and 23.0 percent in 1989, with a "policy" desideratum of 22.1 percent for 1989. Meanwhile, for the same years, national defense outlays as a percent of GNP are set at

6.5 percent, 6.7 percent, 7.7 percent, 7.8 percent, and 7.6 percent. Concurrently, outlays for other or domestic programs in ratio to GNP are set at 15.4 percent, 14.3 percent, 12.9 percent, 12.6 percent, and 12.1 percent.* Regardless of whether national defense outlays should be increased by more or less than is underway, a subject on which I have no expert judgment, the declining trends for total outlays and for domestic outlays are in shocking disregard of economic needs and human or social priorities, or even of reducing the deficit. My Chart 13, developed in the perspective of what might be called a nation's economic budget, represents an approach in accord with what we did during World War II and during my time on the CEA, when we did well. This Chart 13, in accord with achieving the goals of the Humphrey-Hawkins Act through adjusting policy to these goals, sets forth all of these matters in much more detail.

On the top of p. 197 of the CEA Report, Table 6-10 sets forth for 1984 contrasted with 1983 some most disturbing forecasts for declines in the rate of growth of real GNP, personal consumption expenditures, nonresidential fixed investment, and residential investment. These all influence the current trend toward a sharp slowdown in the recovery movement. The sharpest slowdowns, in personal consumption expenditures and residential investment, are entirely antithetical in balanced growth terms to what need to be stimulated greatly, as my earlier analysis indicates. Then, Table 6-11 on the same page, dealing with the Administration's economic assumptions for 1984-1989, forecasts that unemployment will be as high as 7.8 percent in 1984 and 6.1 percent even by 1988, the year now appropriate for achievement of the Humphrey-Hawkins goal of 4.0 percent unemployment and 3.0 percent among adults. And the Table sets forth dwindling rates of growth in real GNP hovering around 4.0 percent from 1985 through 1988, with 1989 the lowest of all. These forecasts may be correctly in line with most other forecasts (and are in some respects consistent with mine as set forth on my Chart 13, although I am somewhat more pessimistic) if one assumes continuation of the current policies and programs of the Administration. But making these dismal and defeatist forecasts is not the task of a potentially great Government in the context of a great American people with the most urgent of unmet needs and the most urgent of economic and social deficiencies. We did not forecast whether we were going to win World War II; we set forth and implemented goals toward that end, and likewise in some later good periods such as 1947-1953. The goal-making process also explains the high economic achievements of the Truman Administration in which I served, and of parts of some later Administrations, as shown on my Chart 29. All that the Employment Act of 1946 and the Humphrey-Hawkins Act of 1978 really import is that we shall endeavor constantly to do our best or nearly our best, instead of resigning ourselves to continuation of what since 1969 at least has been the worst economic and related social performance after World War II.

The climax to this long and poignant evidence of insensivity and irresponsibility, and to what the top problems really are, is to be found in the discussion on pp. 201-203 of the CEA Report. It is a weird jumble of incomprehensibility, inconsistency, and impervious but cocky rejection of responsibilities which would exist even if not so clearly defined by the statutes under which the Council of Economic Advisers operates, and even more clearly defined by the problems of our economic and related social life. The discussion first states on p. 201 that during the last two decades "rising inflation has been associated with rising unemployment." This is called "a key observation from experience," ~~although~~ and our chronic experience has been overwhelmingly ~~to the reverse,~~ in this direction, as demonstrated on my Charts 29 and 30. ~~In~~consistently with this, on p. 202, the discussion states that "From this experience it is clear that rising unemployment and rising inflation can occur together," a belated partial recognition not reflected in policy adhering to the "trade-off." Meanwhile, on p. 201, the discussion assures us of "the achievement of full employment," and that this "goal is also a high priority for this Administration." But on p. 202, after setting forth the goals and timetable of the Full Employment and Balanced Growth Act, the discussion insists that these goals are unattainable within any stated period ahead and it offers in lieu of them the dismal forecasts which I have already depicted. This assumes that we can do no better than what current policies indicate and what would be disastrous if actually experienced. A CEA Chairman who presides over this kind of presentation does not understand the needs of America, our potentials to achieve them, nor even the law which defines his lines of responsibility. This gross repudiation of the law of the land, unconscionably in itself, is utterly in defiance of the minimal requirements for sound and cohesive national Administration policies designed to be effective and to win the confidence of the American people.

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* For the differences between these figures and mine as shown on page 54 of my discussion, see footnote on p. 5.

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Throughout my discussion, I have focused upon the behavior pattern of the Administration, not fundamentally dissimilar from that of some preceding Administrations including those of a different political complexion. I have omitted to point out that the Congress as a whole has done but little effectively to challenge this performance, despite election-time potshots, to offer solid alternative programs, or to effectuate the 1946 and 1978 laws which were enacted by huge majorities in the Senate and the House. My reasons for this treatment are that more than 50 years of experience and study have convinced me that, under the modern American system, the President largely proposes and the Congress largely disposes. Yet I do believe that it is the duty of members of the Congress to press the Administration, to inform the American people better as to why things are going so wrong, to apply correctives, and to help the American people to exert firmer and stronger pressures upon the national Administration. This is the way the American system works, and this is the way I believe it should work.

Again I thank you for this opportunity to be heard, and to set forth my views frankly and fully, unimpeded by excessively polite and timid restraints.

THE "ROLLER-COASTER" ECONOMIC PERFORMANCE: ECONOMIC GROWTH RATES, 1922-1929, 1941-1945, AND 1947-1983 1/

(Uniform Dollars)

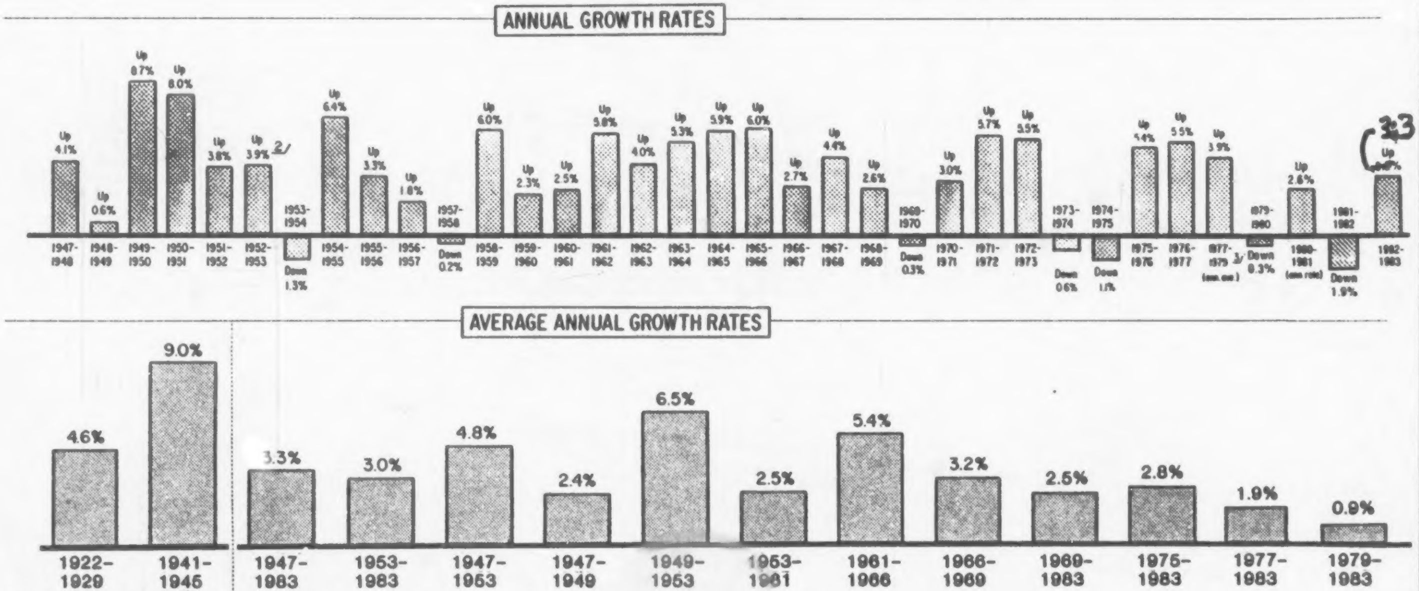


CHART 1

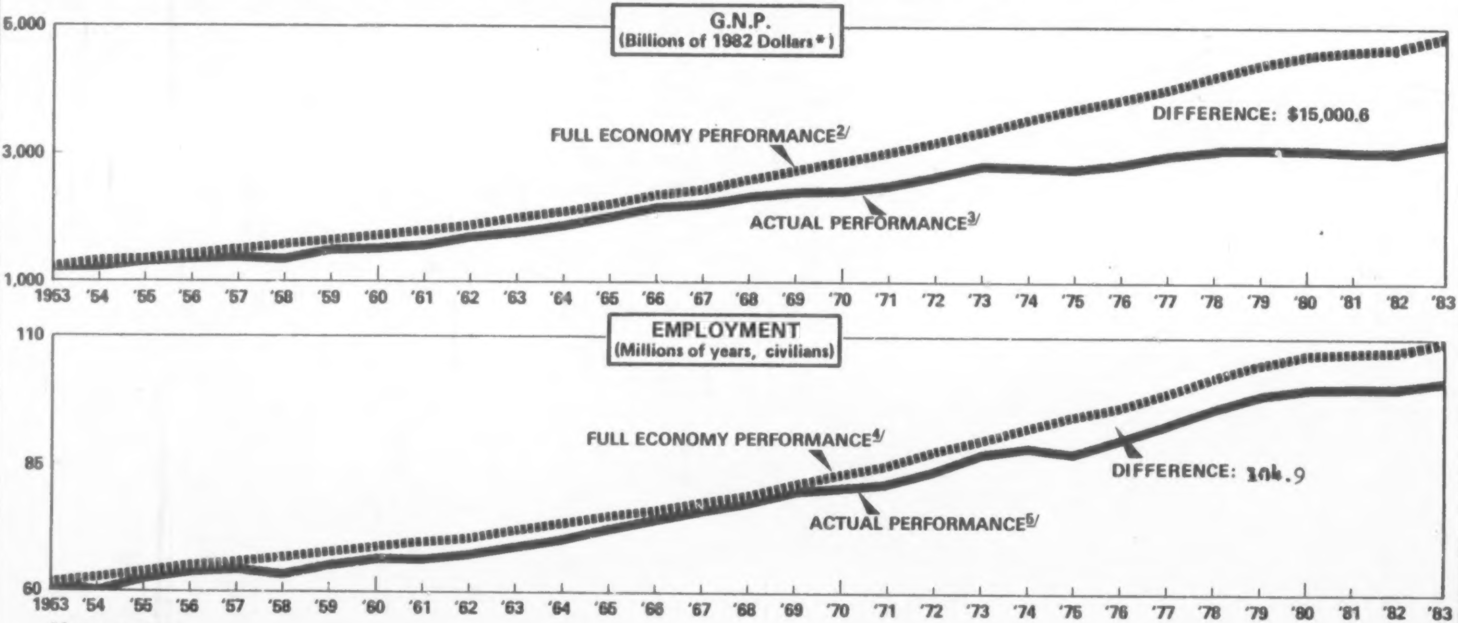
1/ 1983 ~~estimated~~ preliminary

2/ Recession during part of period. There were six recessions, 1953-1983, but some were entirely within one year, and began and ended in different years.

3/ These 2 years combined to leave space for succeeding bars.

CHART 2

COST OF DEPARTURES FROM FULL ECONOMY, 1953—1983 1/



1/ 1983 estimated.
2/ Real average annual growth rate of 4.5 percent.
3/ Real average annual growth rate of 3.0 percent, the 1953-1983 average.
4/ Average true level of unemployment of 4.1 percent, or 2.9 percent full-time unemployment.
5/ Average true level of unemployment of 8.3 percent, or 5.7 percent full-time unemployment.
* In 1983 dollars, all figures are 4.9 percent higher.

Basic Data: Dept. of Commerce; Dept. of Labor.

CHART 3

COSTS OF DEFICIENT ECONOMIC GROWTH U.S. ECONOMY, 1953-1983, AND PROJECTED 1984-1988

(Dollar items in billions of 1982 dollars,* except median family income)

1953-1983 1/

Total National Production (GNP)	Man-years of Employment 2/	Personal Consumption Expenditures	Gov't Outlays for Goods and Services 3/
1953-1983: $15,000.6 1969-1983: 12,639.7 1983: 1,664.4	1953-1983: 104.9 Million 1969-1983: 86.7 Million 1983: 7.8 Million	1953-1983: $6,604.9 1969-1983: 5,552.9 1983: 735.5	1953-1983: $4,227.3 1969-1983: 3,694.8 1983: 403.2
Private Business Investment (Incl. Net Foreign)	Median Family Income (1982 Dollars)	Wages and Salaries	Residential and Commercial Construction
1953-1983: $4,168.4 1969-1983: 3,392.0 1983: 525.7	1953-1983: $120,758 1969-1983: 101,507 1983: 13,472	1953-1983: $7,599.8 1969-1983: 6,389.3 1983: 848.0	1953-1983: $2,067.1 1969-1983: 1,638.4 1983: 184.5

1984-1988 4/

Total National Production (GNP)	Man-years of Employment	Personal Consumption Expenditures	Gov't Outlay for Goods and Services 3/
1984-1988: $1,381.2 1988: 490.5	1984-1988: 16.2 Million 1988: 5.9 Million	1984-1988: $711.8 1988: 269.8	1984-1988: $432.8 1988: 140.8
Private Business Investment (Incl. Net Foreign)	Median Family Income (1982 Dollars)	Wages and Salaries	Residential and Commercial Construction
1984-1988: $216.6 1988: 79.9	1984-1988: $9,031 1988: 3,369	1984-1988: $583.2 1988: 217.5	1984-1988: $150.8 1988: 55.0

1/ Deficits are calculated from 1953 base, because growth rates since then have averaged far too low. 1983 figures estimated. The $1,664.4 billion dollar figure for 1983 represents how far GNP in 1983 was below where it would have been if it had grown from 1953 forward if reasonably full production had been maintained, 1953-1983. But due to the roller coaster performance 1953-1983, a very large part of the plant and productivity potential was irretrievably lost, so that a GNP higher than it actually was in 1983 by 350-400 billion would have been sufficient for a reasonably full economy in that year.

2/ Based upon true level of unemployment, including full-time unemployment, full-time equivalent of part-time unemployment, and concealed unemployment (non-participation in civilian labor force) due to scarcity of job opportunity.

3/ Based upon reasonable relationships to GNP and to government receipts.

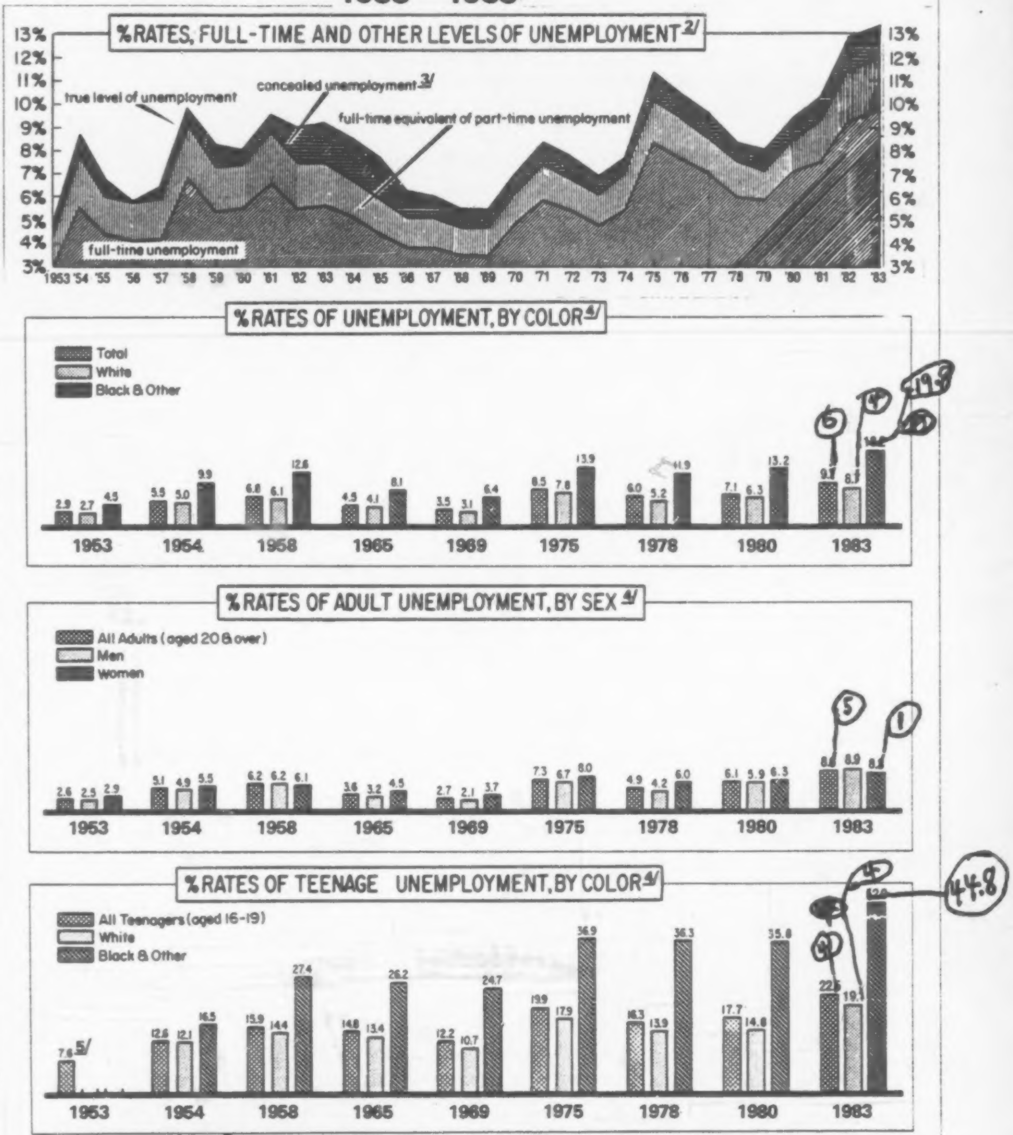
4/ These figures are derived by estimating the differences, during 1984-1988, between continuing current national policies and applying the policies mandated by the Humphrey-Hawkins Act.

* In 1983 dollars, all figures would be about five percent higher.

Basic Data: Dept. of Commerce; Dept. of Labor.

CHART 4

UNEMPLOYMENT, % RATES & DISTRIBUTION, 1953–1983 1/



1/ 1983 [illegible] preliminary.

2/ In deriving these percentages, the officially reported civilian labor force is augmented by concealed unemployment. Thus, some of the rates for full-time unemployment are very slightly lower than in the official reports of full-time unemployment.

3/ Withdrawals from labor force, due to scarcity of job opportunity.

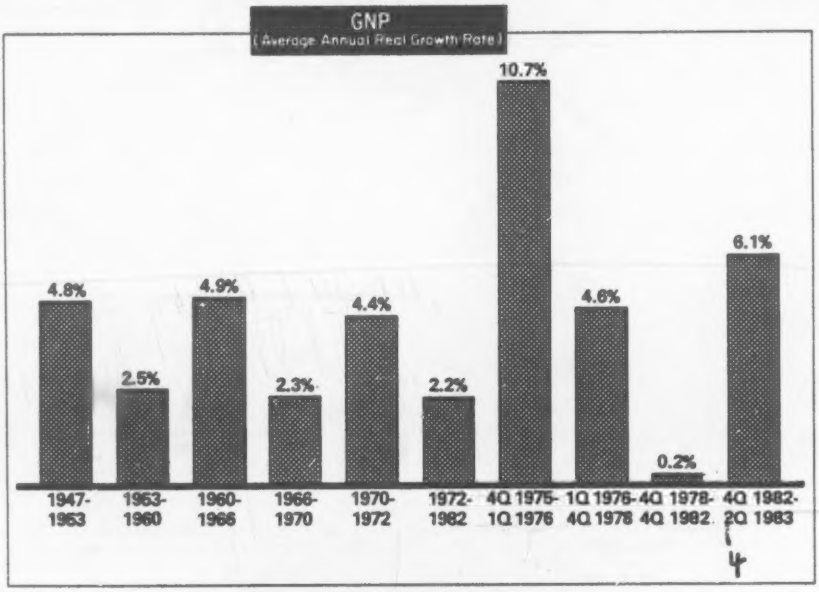
4/ Officially reported concept of full-time unemployment.

5/ Distribution by color unavailable.

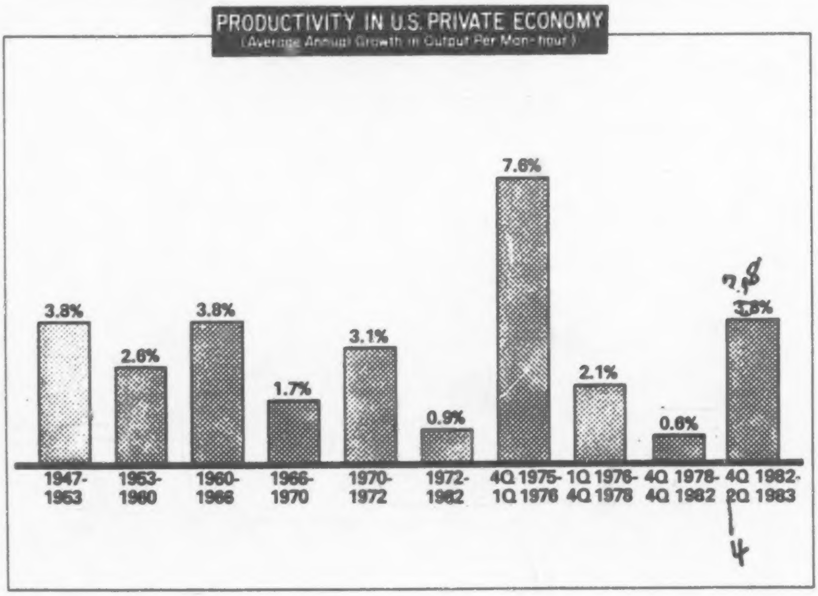
Note: Some totals affected by rounding.

CHART 5

IMPACT OF ECONOMIC GROWTH UPON PRODUCTIVITY GROWTH 1947—2Q 1983



GNP
(Average Annual Real Growth Rate)



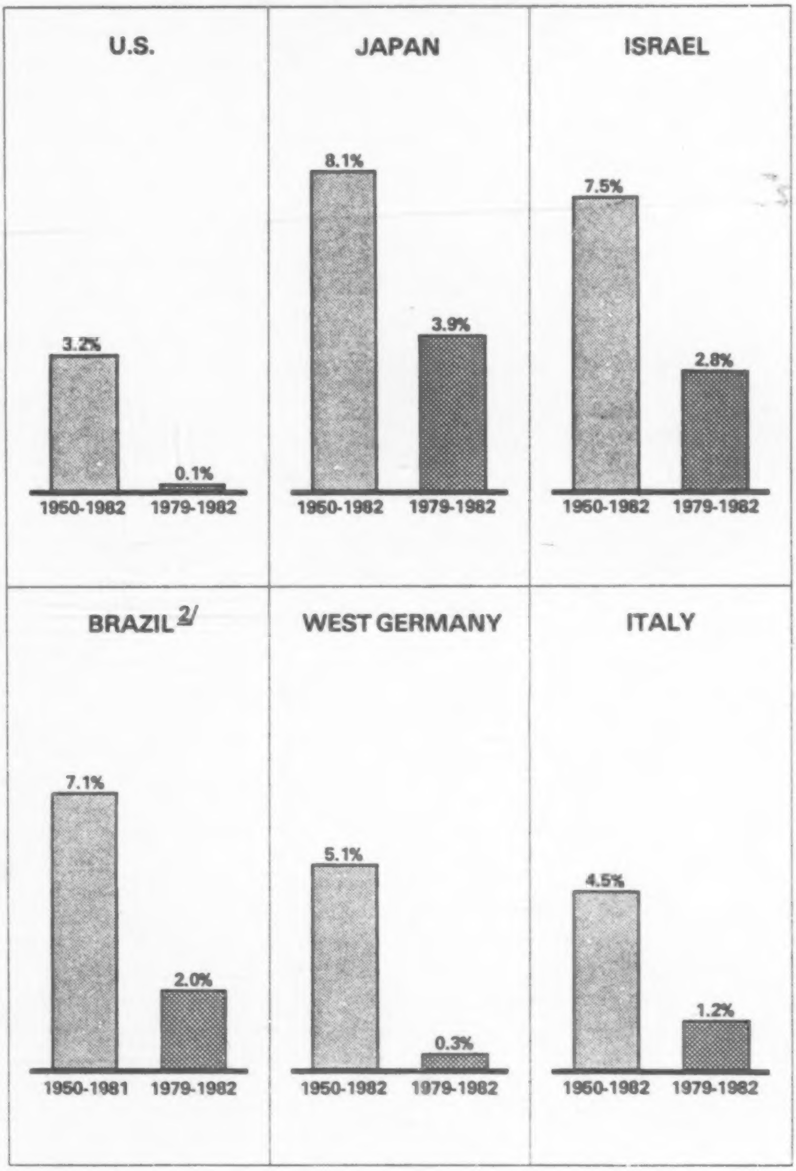
PRODUCTIVITY IN U.S. PRIVATE ECONOMY
(Average Annual Growth in Output Per Man-hour)

Source: Dept. of Labor, Dept. of Commerce

CHART 6

COMPARATIVE REAL ECONOMIC GROWTH RATES VARIOUS COUNTRIES, 1950-1982 AND 1979-1982 1/

Average Annual Rates of Growth



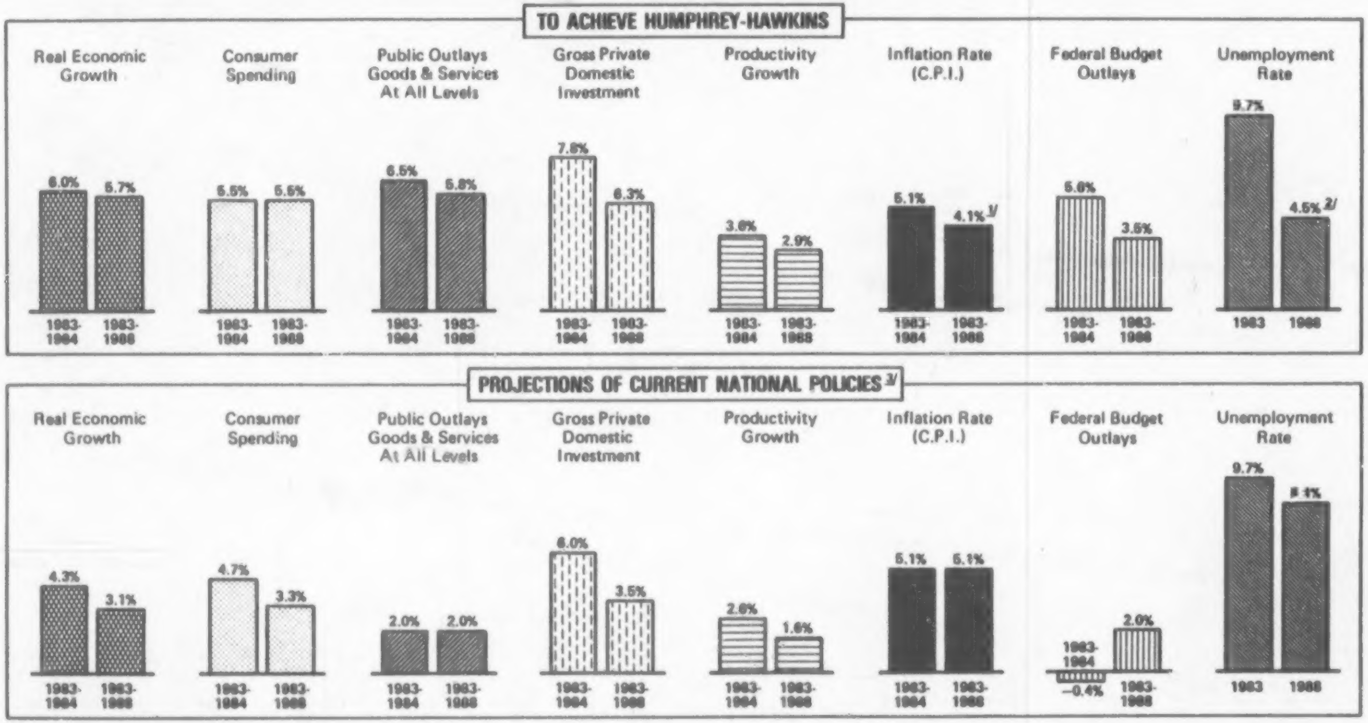
1/ G.N.P. for U.S., Japan, & Germany. Gross domestic product for all other countries.

2/ 1982 not available.

Chart 7

GOALS TO ACHIEVE GOALS OF HUMPHREY-HAWKINS COMPARED WITH PROJECTIONS OF CURRENT NATIONAL POLICIES

(Average Annual Rates in Real Terms)



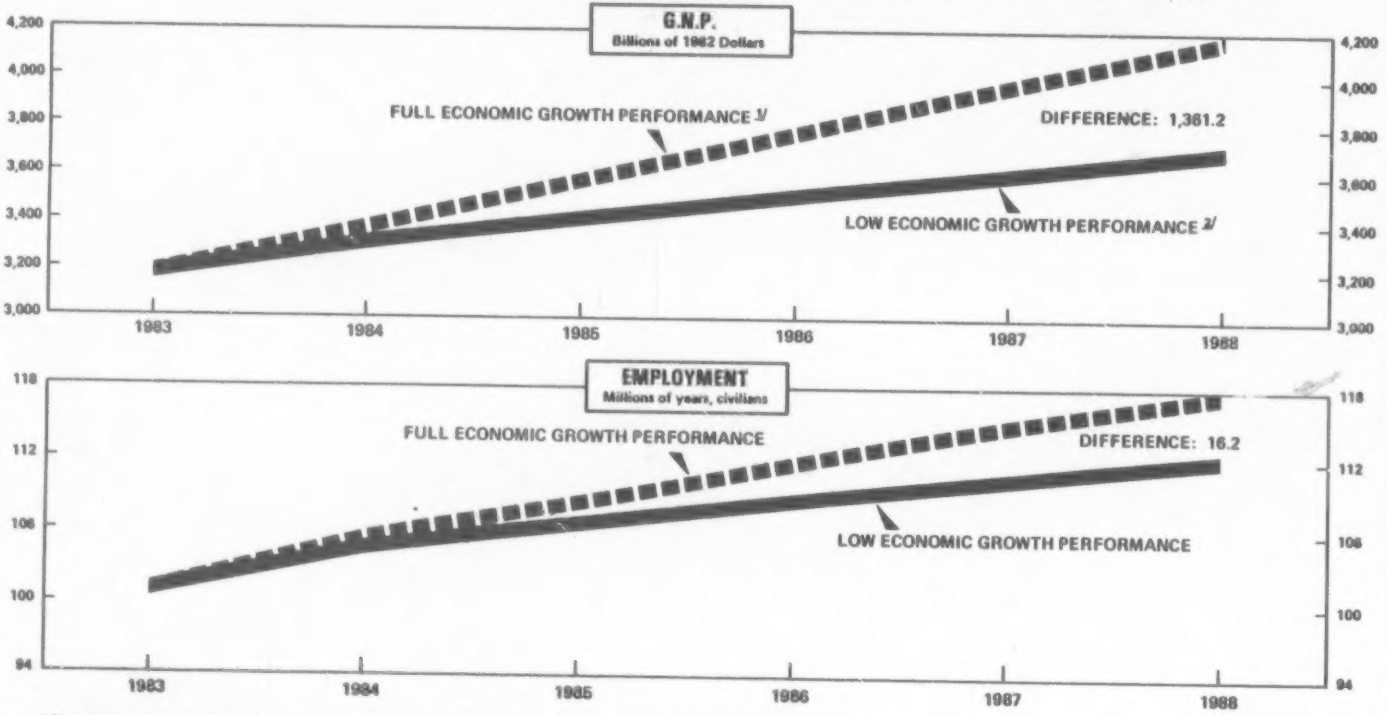
1/ Inflation rate down to 3.0 percent by end of 1988.

2/ Unemployment rate 4.0 percent by end of 1988.

3/ In making these projections, the Conference of Economic Progress has taken account of projections made by the Congressional Budget Office and by others, and its own projections are reasonably in accord.

CHART 8

BENEFITS OF FULL ECONOMIC GROWTH, 1983—1988



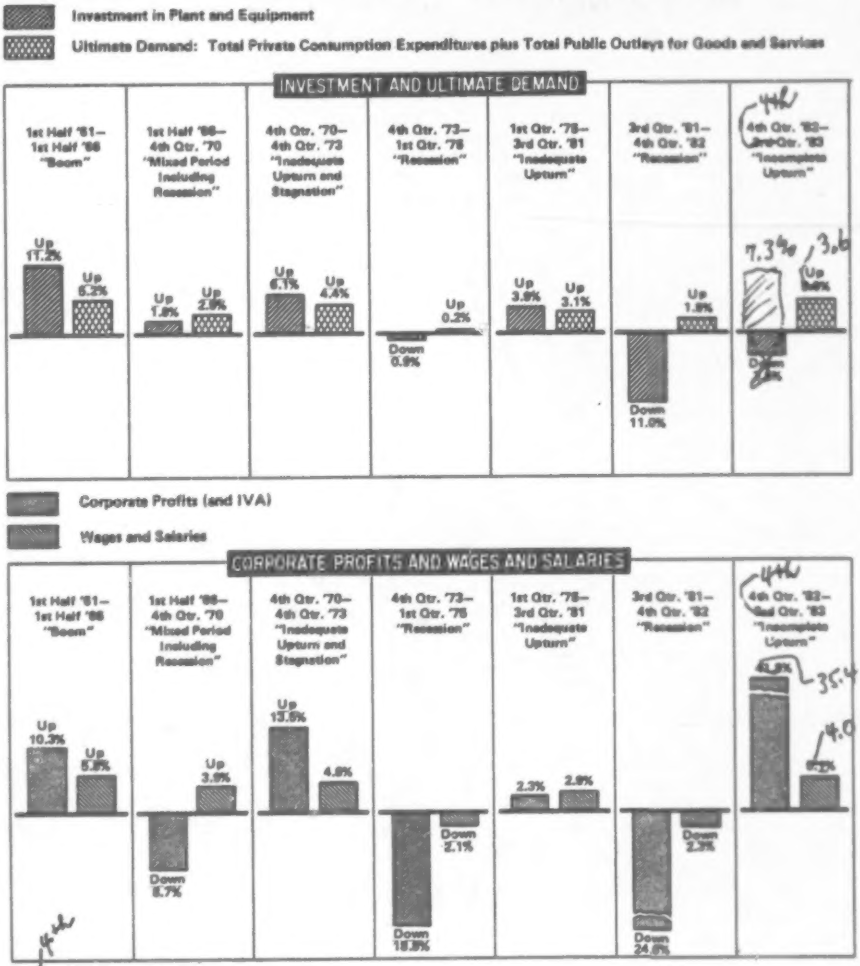
1/ Real growth rate of 6.1%, 1983-1984. Real average annual growth rate of 5.7%, 1983-1988, and 5.6%, 1984-1988. These growth rates would be consistent with reducing overall unemployment to 4% by the end of 1988.

2/ Real average annual growth rate of 3.1%, compared with 2.5%, 1969-1983. (The 4.7% average annual rate, 1983-1988 in the President's 1983 Economic Report is deemed unattainable under policies and programs in such Economic Report).

CHART #9

COMPARATIVE GROWTH RATES, 1961—~~3~~ 4 QTR. 1983 1/

(Average Annual Rates of Change, in Uniform Dollars)

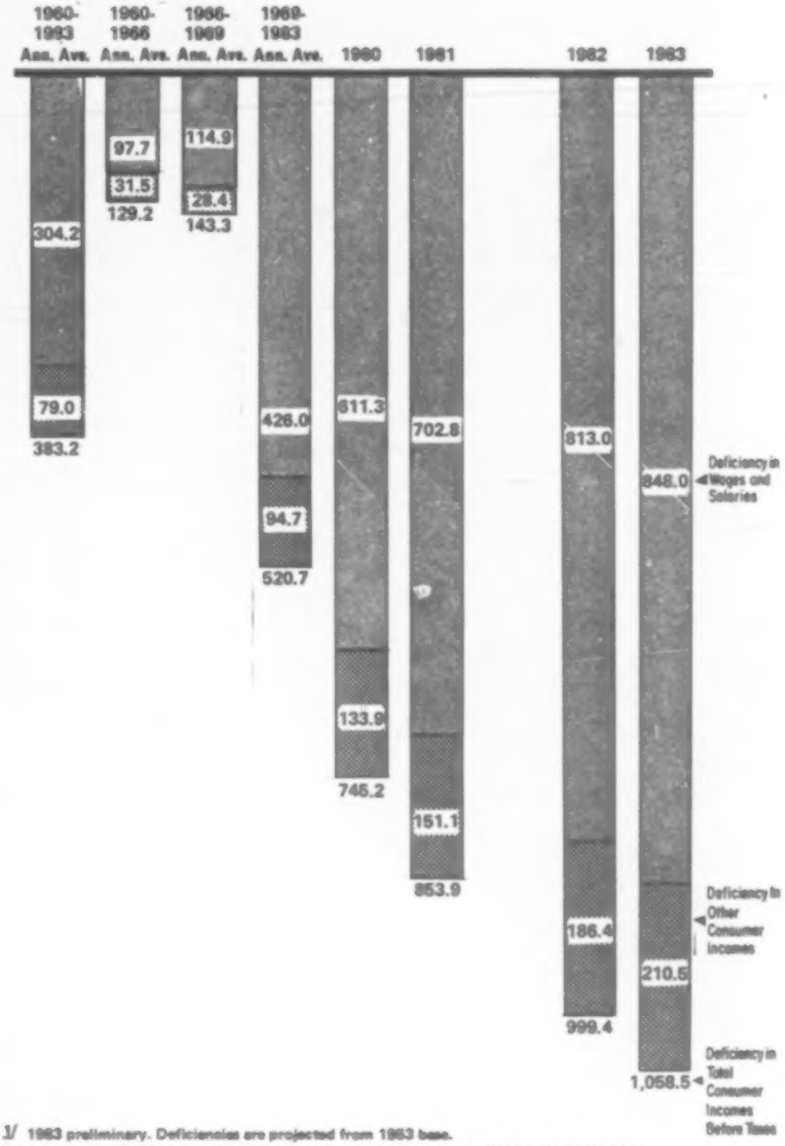


1/ ~~3rd~~ 4th Qtr. 1983 ~~estimated~~ preliminary
Basic Data: Dept. of Commerce.

CHART 10

DEFICIENCIES IN WAGES AND SALARIES ARE LARGE SHARE OF DEFICIENCIES IN TOTAL CONSUMER INCOMES BEFORE TAXES 1/

Billions of 1982 Dollars

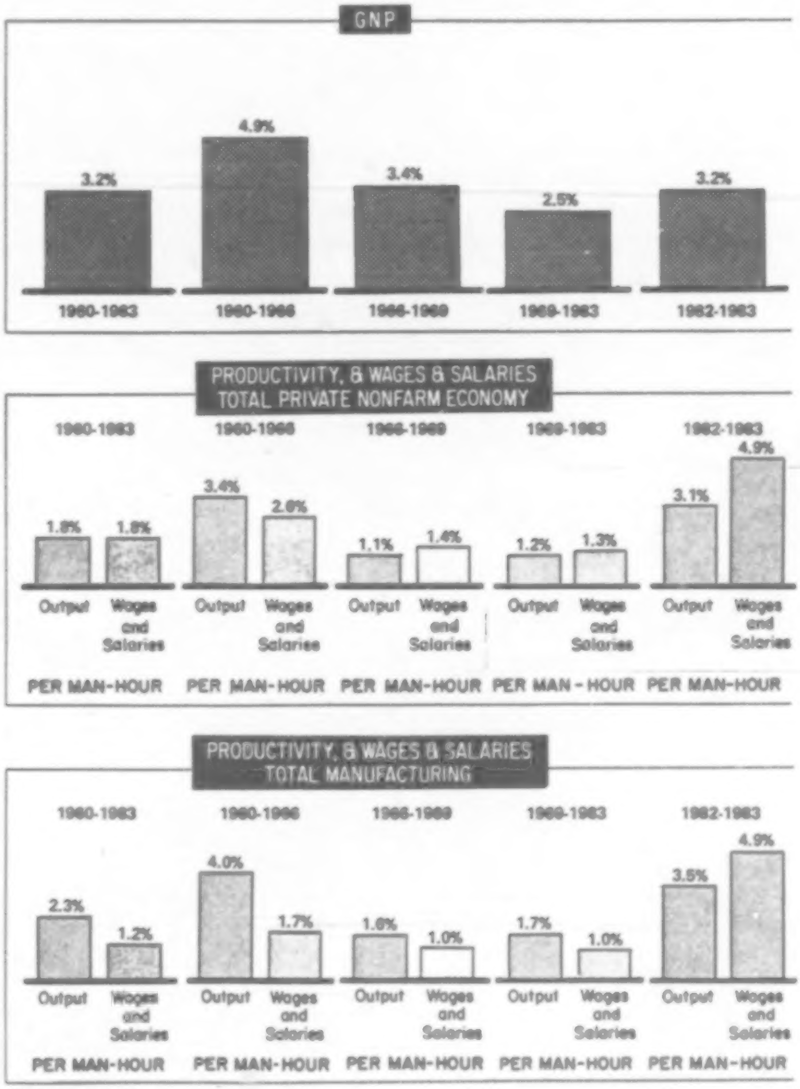


1/ 1983 preliminary. Deficiencies are projected from 1953 base.
Due to nonrecuperable losses, the deficiency in wages and salaries, in 1983, 200–300 billion.

CHART II

THE LONG RANGE LAG IN WAGES AND SALARIES BEHIND PRODUCTIVITY GAINS, 1960-1983 1/

(Average Annual Increases, Constant Dollars)

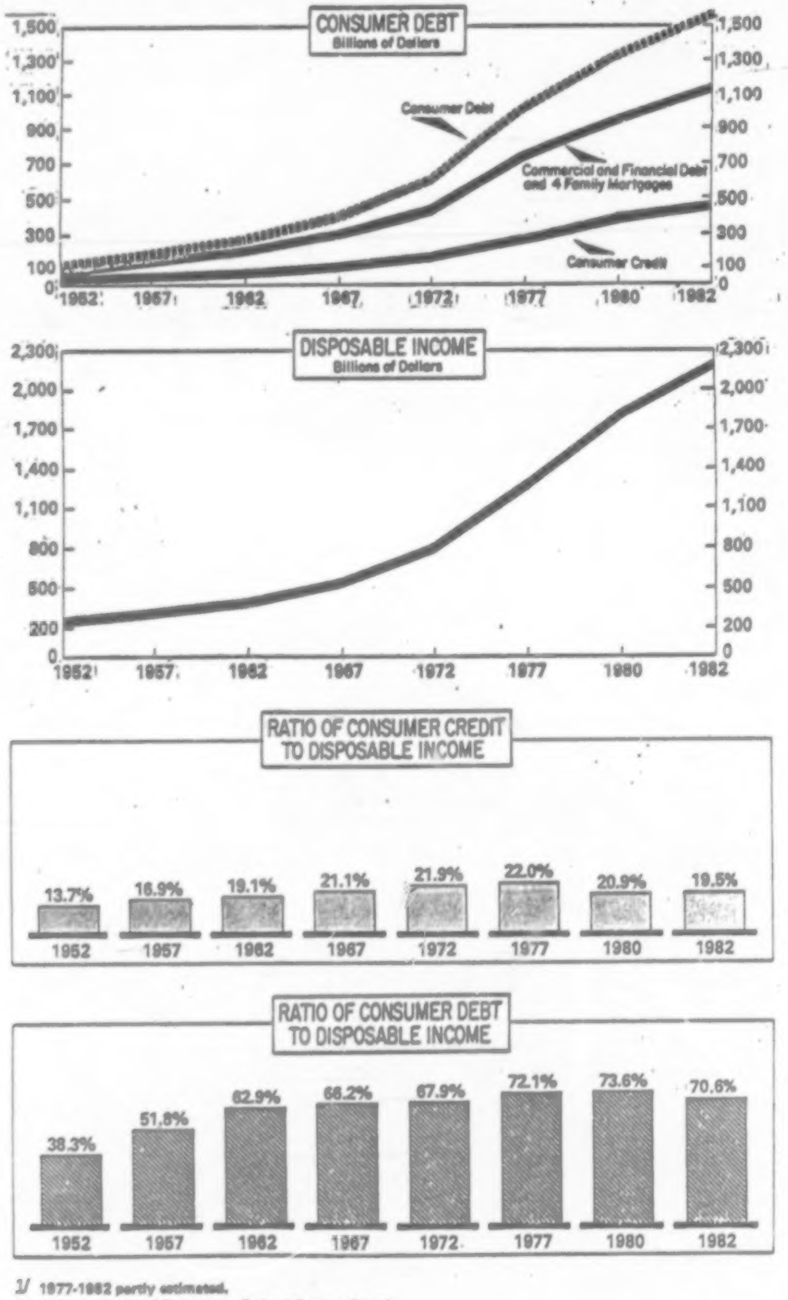


1/ 1983 estimated.

Basic Data: Dept. of Commerce; Dept. of Labor.

CHART 12

RISING CONSUMER CREDIT AND DEBT IN RATIO TO DISPOSABLE INCOME, 1972-1982



1/ 1977-1982 partly estimated.
Basic Data: Dept. of Commerce, Federal Reserve Board.

all Federal outlays
President's Budget 1985 883.7 3,711.47 23.79
nat. defense etc. 284.9 1196.56 7.69
domestic programs 598.8 3,514.91 16.12

GOALS FOR A MODEL FEDERAL BUDGET, FISCAL 1984, 1985, 1988 AND CALENDAR 1988 COMPARED WITH ACTUAL BUDGET, FISCAL 1982, 1983, AND PRESIDENT'S BUDGET FOR FISCAL 1984[1] and 1985

(in billions of fiscal 1984 dollars)

[Since all figures are in 1984 dollars, they differ from those when shown in current dollars in official reports]

	ALL FEDERAL OUTLAYS			NATIONAL DEFENSE INTERNATIONAL AFFAIRS, SCIENCE AND SPACE			DOMESTIC PROGRAMS[2]			INCOME SECURITY, OTHER THAN VETERANS (Excluding Subsidized Housing)			MANPOWER PROGRAMS, INCLUDING PUBLIC SERVICE JOBS		
	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP
Actual Budget, 1982	802.0	3,471.36	23.85	225.2	974.89	6.70	576.8	2,496.97	17.15	264.6	1,145.45	7.87	6.7	28.83	0.20
Estimated Budget, 1983	851.8	3,651.09	26.01	246.7	1,057.44	7.24	605.1	2,593.66	17.76	287.0	1,230.18	8.43	6.1	26.06	0.18
President's Budget, 1984	848.5	3,599.92	23.73	266.8	1,131.96	7.46	581.7	2,467.97	16.27	271.6	1,152.31	7.60	5.4	22.91	0.15
Goals for Fiscal 1984	899.4	3,815.87	24.92	264.0	1,120.07	7.31	635.4	2,695.80	17.60	287.0	1,217.65	7.96	19.4	82.31	0.54
Goals for Fiscal 1985	926.4	3,890.80	23.18	271.9	1,141.96	7.10	654.5	2,748.86	17.09	290.7	1,220.92	7.59	20.7	86.94	0.54
Goals for Fiscal 1988	1,012.3	4,121.74	22.51	297.2	1,210.10	6.61	715.1	2,911.64	15.90	308.6	1,256.51	6.86	24.3	98.94	0.54
Goals for Calendar 1988	1,019.9	4,140.89	22.39	299.4	1,215.59	6.57	720.5	2,925.29	16.82	309.5	1,256.60	6.80	24.6	99.88	0.54

	TRANSPORTATION			AGRICULTURE, NATURAL RESOURCES, ENVIRONMENT AND ENERGY			EDUCATION			HEALTH			HOUSING AND COMMUNITY DEVELOPMENT		
	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP
Actual Budget, 1982	22.7	98.27	0.68	35.8	154.98	1.06	16.7	67.97	0.47	81.5	352.81	2.42	13.9[3]	60.17	0.41
Estimated Budget, 1983	23.0	98.59	0.68	39.7	170.17	1.17	15.1	64.72	0.44	86.7	371.62	2.56	14.8[3]	63.44	0.43
President's Budget, 1984	25.1	106.49	0.70	25.3	107.34	0.71	13.5	57.28	0.38	90.6	384.39	2.53	15.2[3]	64.49	0.43
Goals for Fiscal 1984	25.5	108.19	0.71	40.0	169.71	1.11	17.0	72.13	0.47	91.5	388.21	2.54	20.0	84.86	0.56
Goals for Fiscal 1985	27.2	114.24	0.71	41.0	172.20	1.07	18.0	75.60	0.47	95.8	402.35	2.50	21.1	88.62	0.55
Goals for Fiscal 1988	31.5	128.26	0.70	42.7	173.86	0.95	21.1	85.91	0.47	110.2	448.70	2.46	24.7	100.57	0.55
Goals for Calendar 1988	31.9	129.52	0.70	43.3	175.80	0.95	21.4	86.89	0.47	111.6	453.11	2.45	25.1	101.91	0.56

[1] Dollar goals would be higher to extent of further inflation. None of the items includes off-budget Federal entities.

[2] Includes categories other than those listed in detail, i.e., commerce and housing credit, area and regional development, disaster relief and insurance, social services, veterans' benefits, administration of justice, general government, general purpose fiscal assistance, interest, allowances, and undistributed offsetting receipts.

[3] The housing portion of these figures — $8.9 billion in 1982, $10.1 billion in 1983, and $12.0 billion in 1984 — appears in "income security" in the President's Budget. The proposed goals for housing are $15.0 billion in 1984, $16.8 billion in 1985, $18.6 billion in fiscal 1988 and $18.8 billion in calendar 1988.

Note: Population — 231.0 million for April 1, 1982; 233.3 million for April 1, 1983; 235.7 million for April 1, 1984; 238.1 million for April 1, 1985; 245.6 million for April 1, 1988; and 246.3 million for July 1, 1988.

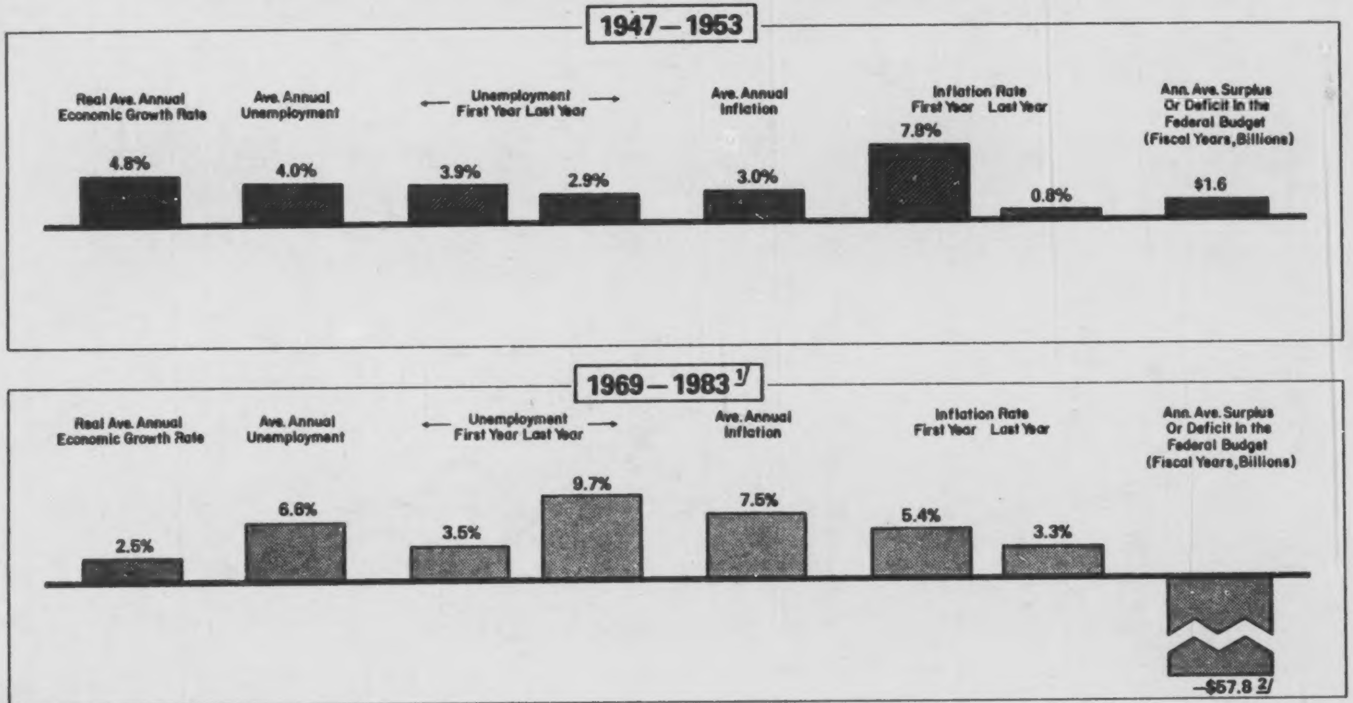
GNP — $3,362.4 billion for fiscal 1982; $3,408.5 billion for fiscal 1983; and $3,575.8 billion for fiscal 1984 and 3,705.1 for fiscal 1985. Goals, for fiscal 1984, $3,609.4 billion; for fiscal 1985, $3,830.8 billion; for fiscal 1988, $4,497.7 billion; and for calendar 1988, $4,554.6 billion.

Basic Data: Office of Management and Budget and Department of Commerce.

CHART #13

CHART 14

ECONOMIC PERFORMANCE AND THE FEDERAL BUDGET



1/ All 1983 figures estimated.

2/ Deficit FY '83 is estimated at $225 billion, including off-budget Federal entities.

Source: Dept. of Commerce; Office of Management and Budget.

~~Chart 20~~

FROM FEDERAL DEFICITS IN AN UNHEALTHY ECONOMY TO A HEALTHY BUDGET IN A HEALTHY ECONOMY*

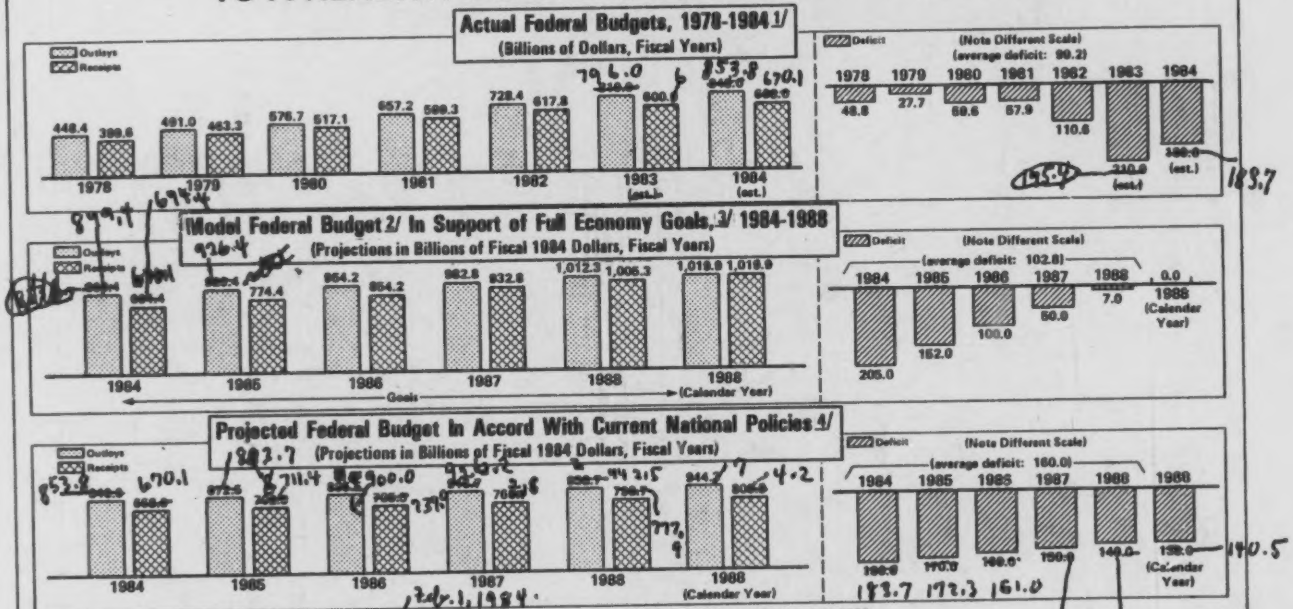


Chart 15

1/ President's Budget, estimate as sent to the Congress on ~~Jan. 31, 1983 and amended for 1983 and 1984 by Mid-Session Review, July 1983.~~ Feb. 1, 1984.

2/ Model Federal Budget outlays depicted in detail on another chart. Goals would be higher in each year's dollars to extent prices rise above fiscal 1984 dollars.

3/ Full economy goals shown on another chart.

4/ Outlays, President's ~~1984 Budget except 1988, which are projected by CEP from President's fiscal 1987 figure. Receipts for fiscal 1984 as in President's Budget, as revised in Mid-Session Review~~ 1985. Later receipts estimated by CEP, based upon 3.5% average annual rate of real economic growth, 1983-1988 (President's 4.7% rate deemed too optimistic under projection of current policies and programs.) Use of 1984 dollars makes figures somewhat different from official Reports.

* Budget outlays exclude off-budget federal entities which increase the deficits, by about ~~20~~ 15 billion dollars in the fiscal 1984 Budget.

Basic Data: Office of Management and Budget for actual Federal Budget.

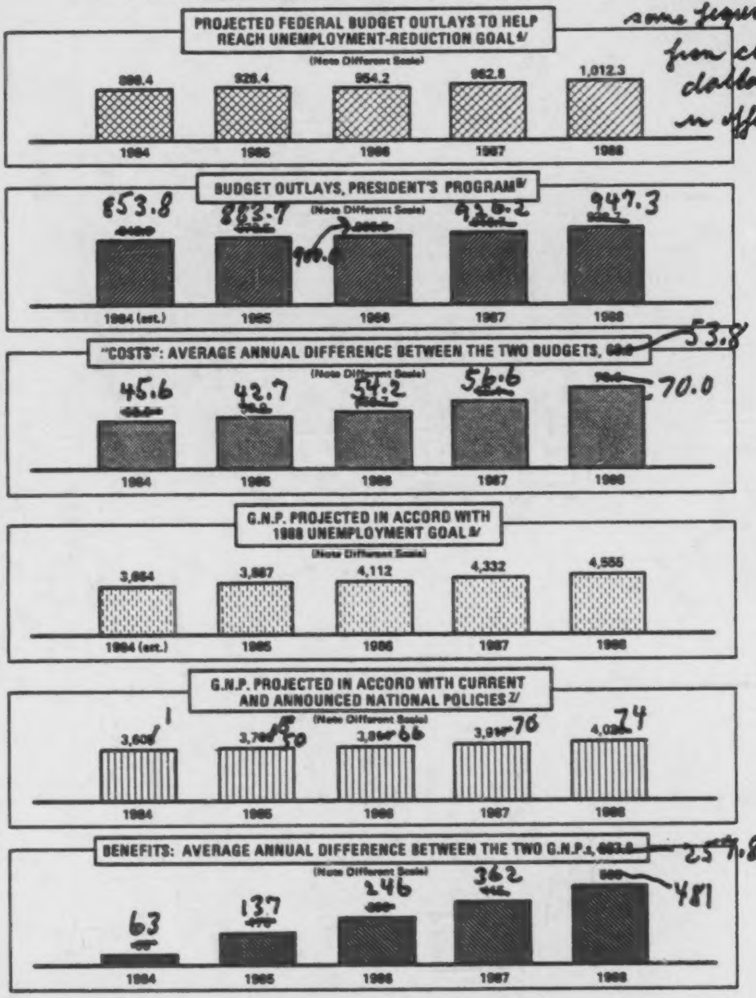
1R. is for 1984 and 1985 as in President's Budget.

CHART ~~#~~ 16

"COSTS"1/ & BENEFITS2/ THROUGH 1988, CONSISTENT WITH REACHING UNEMPLOYMENT-REDUCTION GOAL3/ BY 1988

(Budget, fiscal years; G.N.P., calendar years; billions of fiscal year 1984 dollars)

[Due to 1984 dollars thruout, some figures differ from current dollar figures in official Reports]



1/ "Costs" are difference between Federal Budget outlays needed to help achieve 1988 unemployment-reduction goal and 1984-1988 Budget outlays projected with reasonably estimated projections of recent policies and programs.

2/ Benefits are difference between G.N.P. in accord with 1988 unemployment-reduction goal and G.N.P. projected in accord with reasonably estimated projections of recent national policies and programs.

3/ 4 percent unemployment (3.0% adult) by end of 1988.

4/ The average annual real growth rate in Budget outlays used for these projections is 4.0 percent, projected from fiscal 1983.

5/ The lower Budget is at 2.6 percent real average annual rate, 1983-1988.

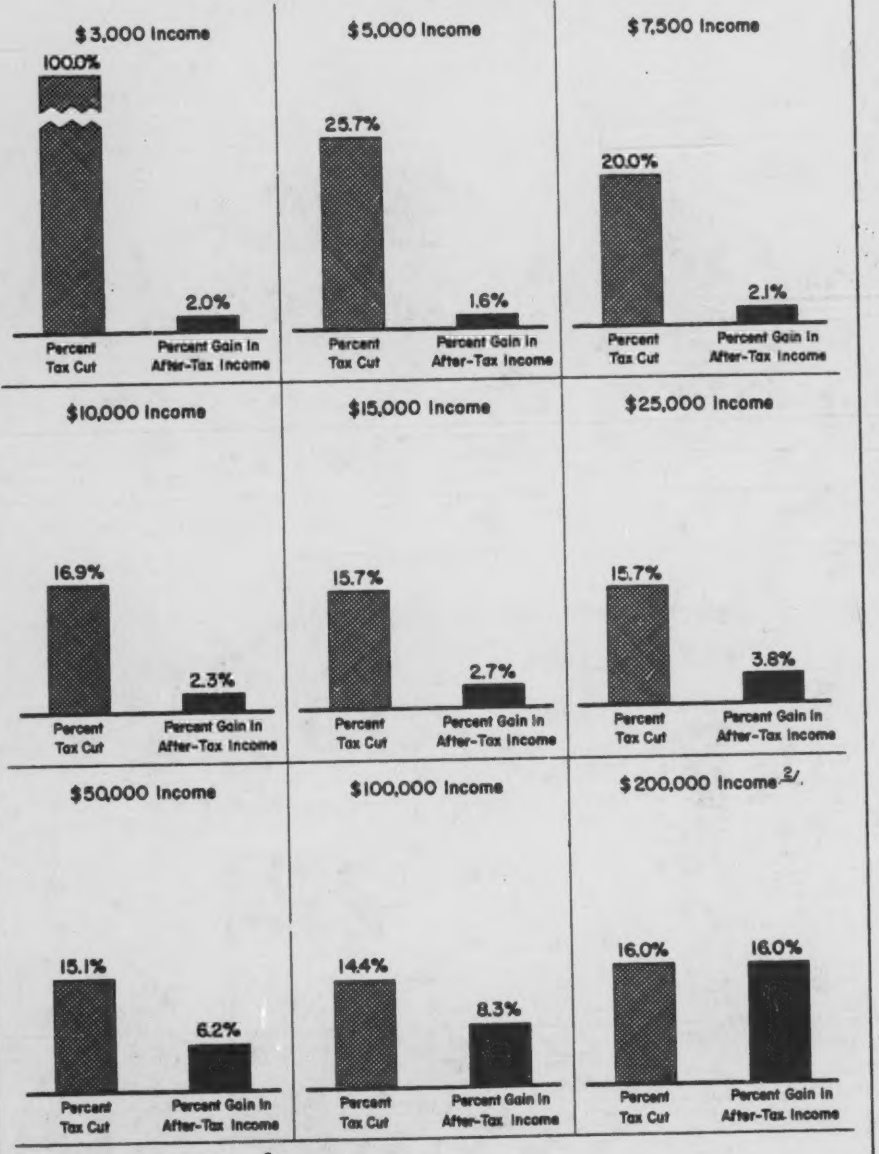
6/ The real average annual growth rate used for these projections is 5.8 percent, projected from calendar 1983.

7/ Average annual growth rate projected at about 3.5 percent from calendar 1983.

CHART ~~12~~ 17

1964 TAX ACT, PERSONAL TAX CUTS

Percent Tax Cut And Percent Gain In After-Tax Income
Married Couple With Two Children At Various Income Levels [1]



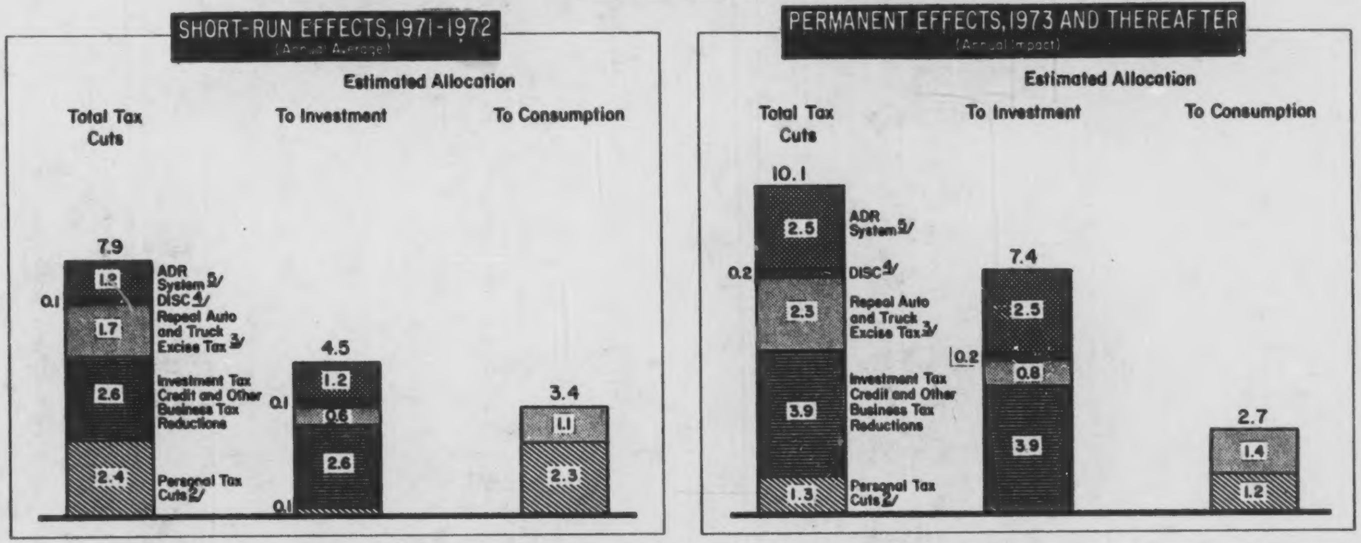
[1] Adjusted gross income levels. [2] Estimated

Note: Standard deductions for $ 3,000 income level. Typical itemized deductions for other income levels.

CHART 18

ALLOCATION OF 1971 TAX CUTS[1]: BETWEEN INVESTMENT AND CONSUMPTION

(Billions of Dollars)



[1] H.R. 10947, as reported by the House-Senate Conference Committee, and Asset Depreciation Range (ADR) System promulgated by the Treasury Department.

[2] Allocation to investment based on portion of cuts for those with income over $15,000, which they would save; remainder allocated to consumption.

[3] Allocation between investment and consumption based on business or nonbusiness use of vehicles.

[4] Tax deferral by Domestic International Sales Corporations (DISCs).

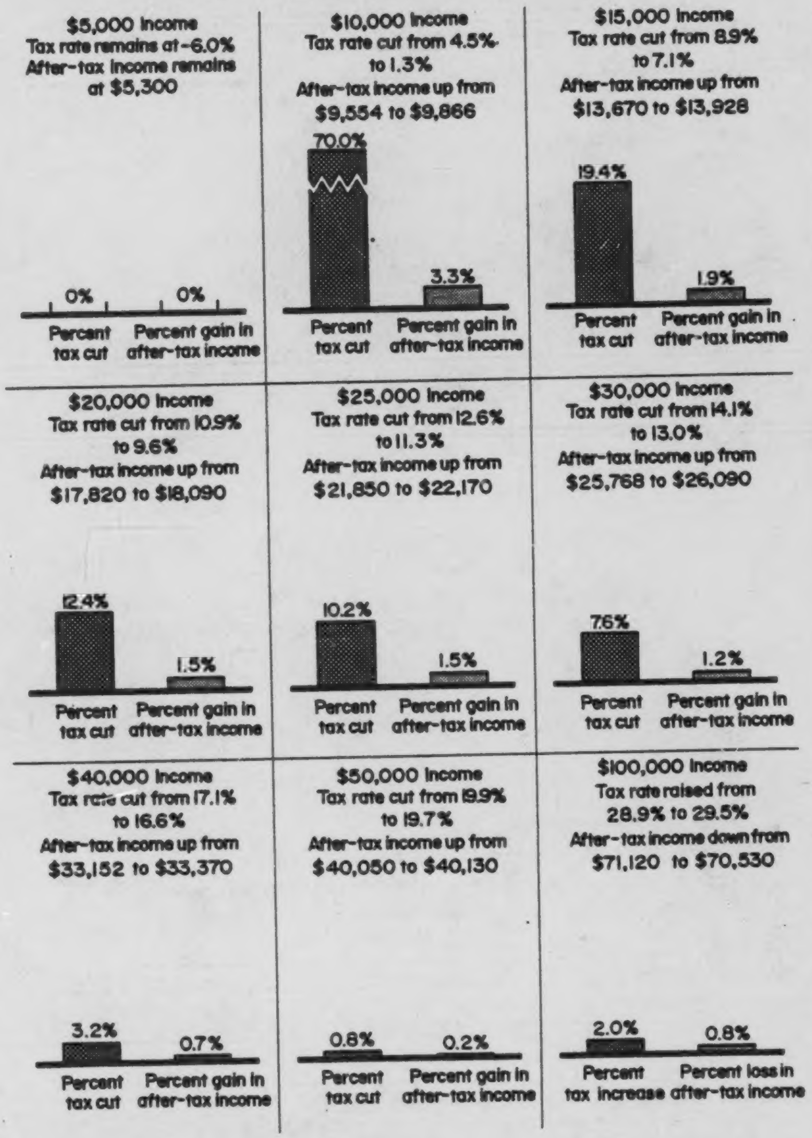
[5] Treasury regulations as modified by H.R. 10947 as reported by the conference committee.

Note: Components may not add exactly to totals, owing to rounding.

CHART #19

ADMINISTRATION PROPOSAL, PERSONAL TAX CUTS IN '79 EXCLUDING SOCIAL SECURITY (FICA) TAX CHANGES

Percent Tax Change and Percent Change in After-Tax Income
Married Couple with Two Children at Various Wage Income Levels 1/



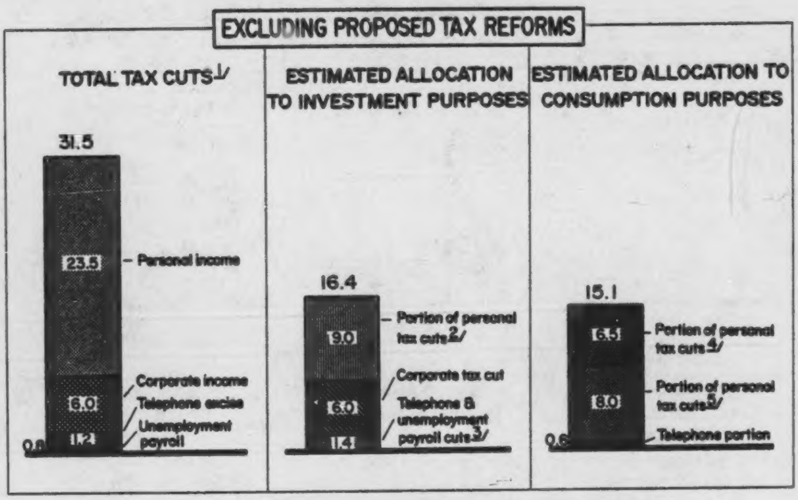
1/ One wage earner; deductible expenses assumed at 20 percent of income.

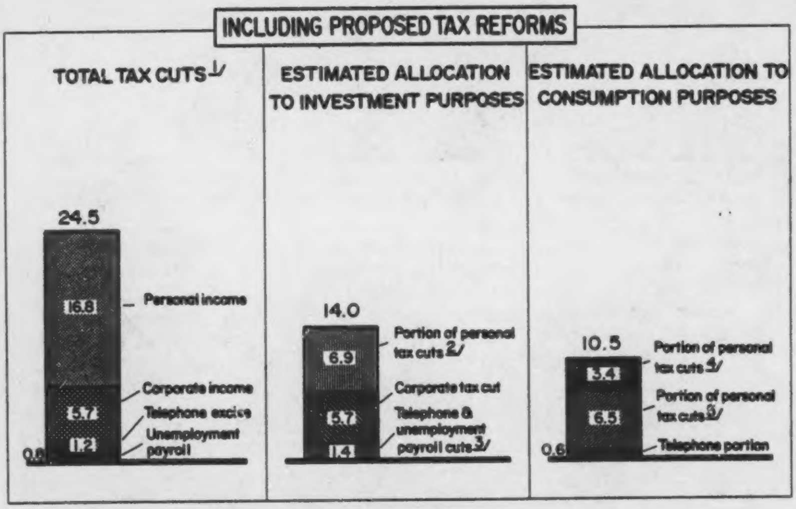
Source: Department of the Treasury, Office of Tax Analysis

CHART 26

ESTIMATED DIVISION--PROPOSED TAX CUT BETWEEN CUTS FOR INVESTMENT PURPOSES AND CUTS FOR CONSUMPTION PURPOSES

(Effects on Calendar 1979 Tax Liability)





1/ Total tax cuts for calendar 1979, as estimated by Department of the Treasury.

2/ L.H.K. estimate of portion of personal tax cuts for those with incomes of $15,000 and over.

3/ L.H.K. estimate of portion of telephone excise cut going for investment.

4/ L.H.K. estimate of portion of personal tax cuts for those with incomes of $15,000 and over which would be spent for consumption.

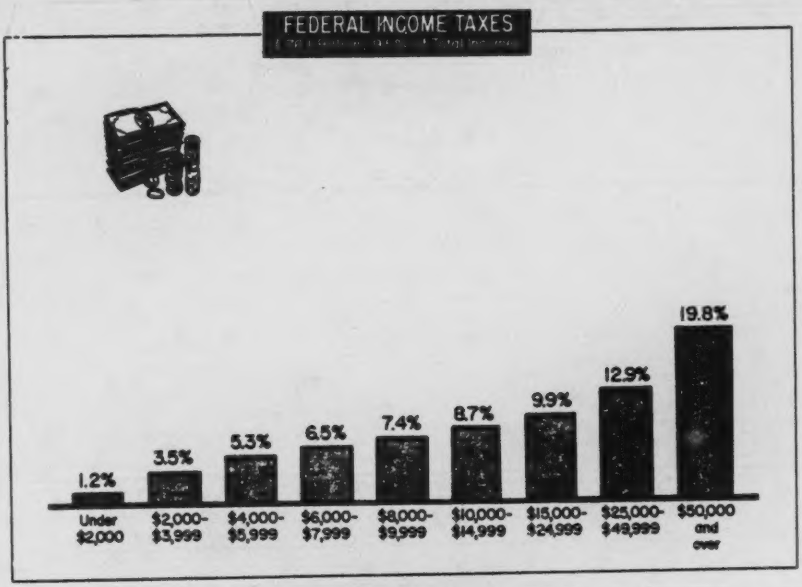
5/ L.H.K. estimates of personal tax cuts for those with incomes under $15,000.

CHART #21

TAXES PAID AS PERCENT OF INCOME, U.S. 1968[1]

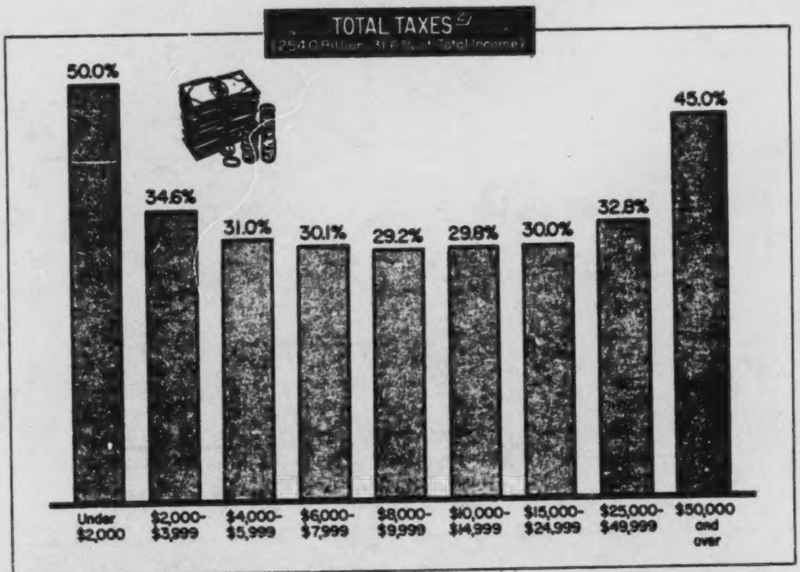
FEDERAL INCOME TAXES

([illegible])



TOTAL TAXES[2]

(254.0 Billion, 31.6% of Total Income)



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[1] Income relates to total income of all persons in the adjusted money income classes shown. Total income is adjusted money income, plus imputed income, less direct taxes, plus retained corporate earnings, plus taxes minus transfer payments, plus realized capital gains.

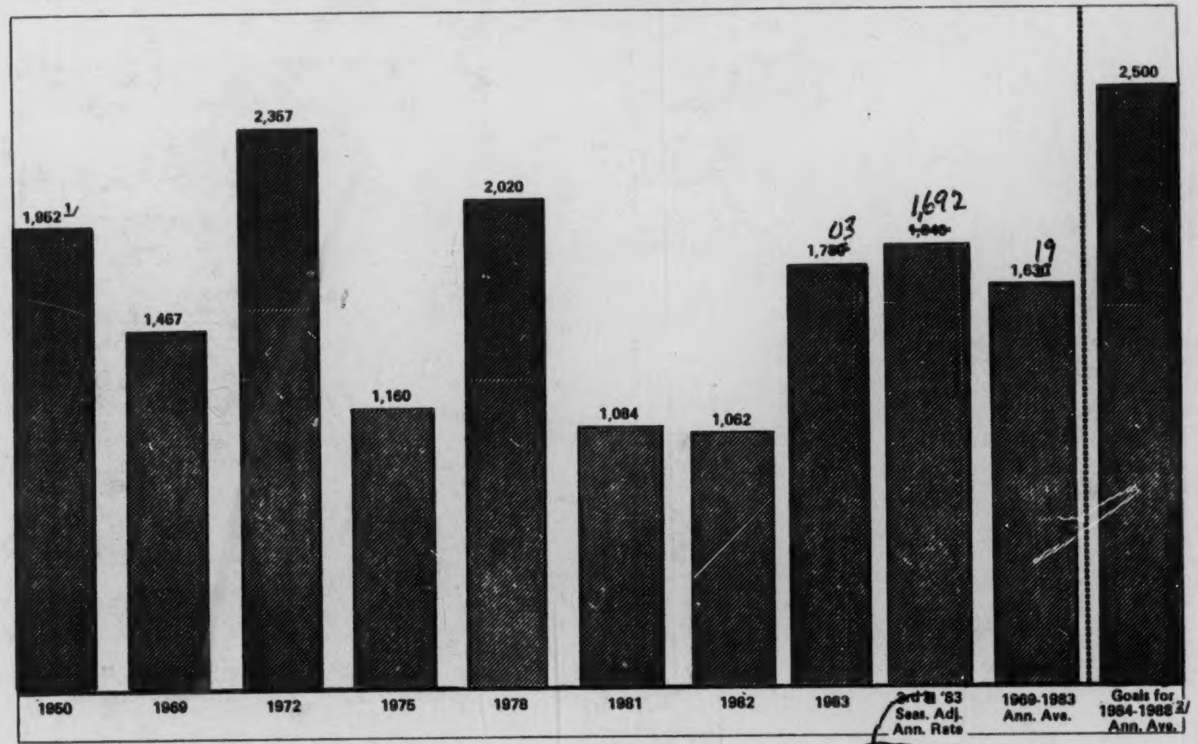
[2] Includes the following Federal and State and Local taxes: Individual income, estate and gift, corporate profits, and social security. Also includes Federal excise and customs taxes, and State and Local sales taxes, motor vehicle licenses, property taxes, and miscellaneous other taxes.

Basic Data: Dept. of Commerce, Bureau of the Census

CHART 22

HOUSING STARTS, 1950-1983 AND GOALS FOR 1984-1988

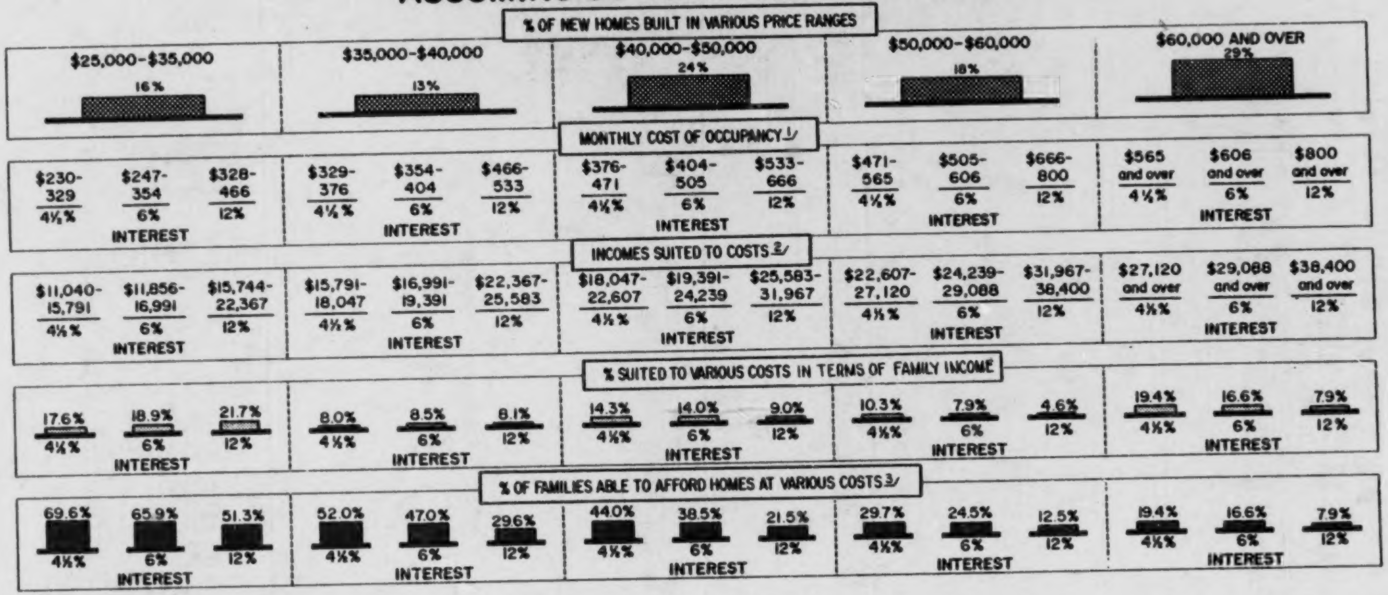
(Thousands of Units)



1/ Non-farm only; farm not available.
2/ Based on home construction needs and its role in attaining full economy goals.
Estimate includes quantitative needs for population growth and shifts, and for overcrowding. If reduction of substandard housing is included, estimate rises to about 3 million.
Source: Dept. of Commerce, Bureau of the Census

CHART 23

NEW HOMES BUILT AT VARIOUS PRICE RANGES AND COSTS, AND FAMILY INCOMES RELATED TO THESE COSTS, 1977 ASSUMING 30 YEAR AMORTIZATION



Price range	Interest	% OF NEW HOMES BUILT IN VARIOUS PRICE RANGES	MONTHLY COST OF OCCUPANCY [1]	INCOMES SUITED TO COSTS [2]	% SUITED TO VARIOUS COSTS IN TERMS OF FAMILY INCOME	% OF FAMILIES ABLE TO AFFORD HOMES AT VARIOUS COSTS [3]
$25,000-$35,000	4½%	16%	$230-329	$11,040-15,791	17.6%	69.6%
	6%		$247-354	$11,856-16,991	18.9%	65.9%
	12%		$328-466	$15,744-22,367	21.7%	51.3%
$35,000-$40,000	4½%	13%	$329-376	$15,791-18,047	8.0%	52.0%
	6%		$354-404	$16,991-19,391	8.5%	47.0%
	12%		$466-533	$22,367-25,583	8.1%	296%
$40,000-$50,000	4½%	24%	$376-471	$18,047-22,607	14.3%	44.0%
	6%		$404-505	$19,391-24,239	14.0%	38.5%
	12%		$533-666	$25,583-31,967	9.0%	21.5%
$50,000-$60,000	4½%	18%	$471-565	$22,607-27,120	10.3%	29.7%
	6%		$505-606	$24,239-29,088	7.9%	24.5%
	12%		$666-800	$31,967-38,400	4.6%	12.5%
$60,000 AND OVER	4½%	29%	$565 and over	$27,120 and over	19.4%	19.4%
	6%		$606 and over	$29,088 and over	16.6%	16.6%
	12%		$800 and over	$38,400 and over	7.9%	7.9%

[1] Total monthly costs, with variations in costs due to variations in interest rates only. 25% down payment assumed throughout.

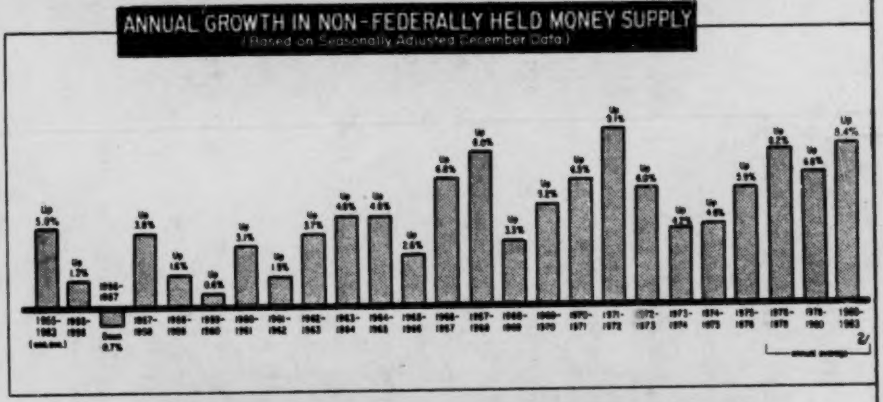
[2] Applicable incomes are monthly costs times 12 times 4.

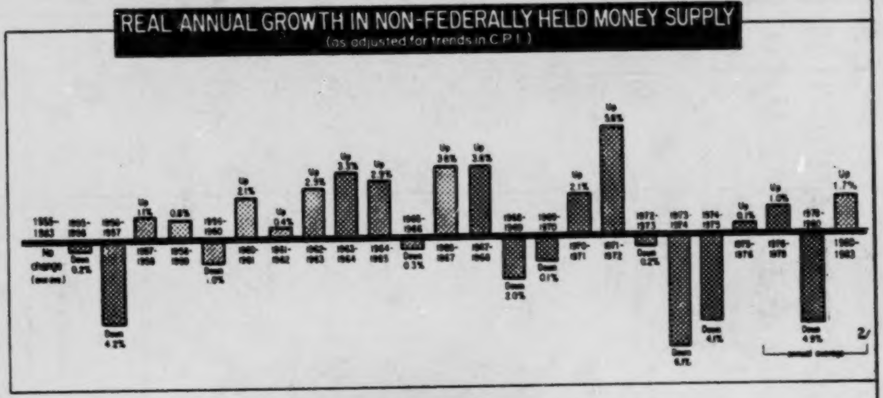
[3] Includes all families from bottom to top who can afford houses in each cost range. About 30% of all families have incomes below cost requirements even for $25,000-35,000 homes at 4 1/2% interest, and about 49% are below at 12% interest.

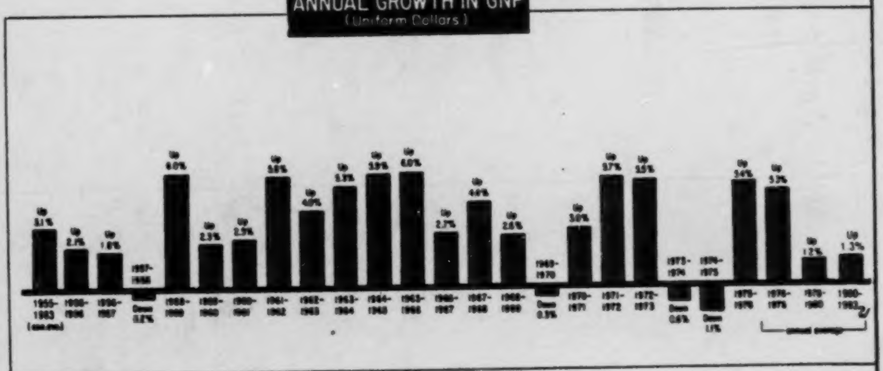
Basic Data: Dept. of Housing and Urban Development, Dept. of Commerce, Library of Congress

CHART #24

COMPARATIVE TRENDS IN NON-FEDERALLY HELD MONEY SUPPLY AND G.N.P., 1955—1983 1/


ANNUAL GROWTH IN NON-FEDERALLY HELD MONEY SUPPLY
(Based on Seasonally Adjusted December Data)


REAL ANNUAL GROWTH IN NON-FEDERALLY HELD MONEY SUPPLY
(as adjusted for trends in C.P.I.)


ANNUAL GROWTH IN GNP
(Uniform Dollars)

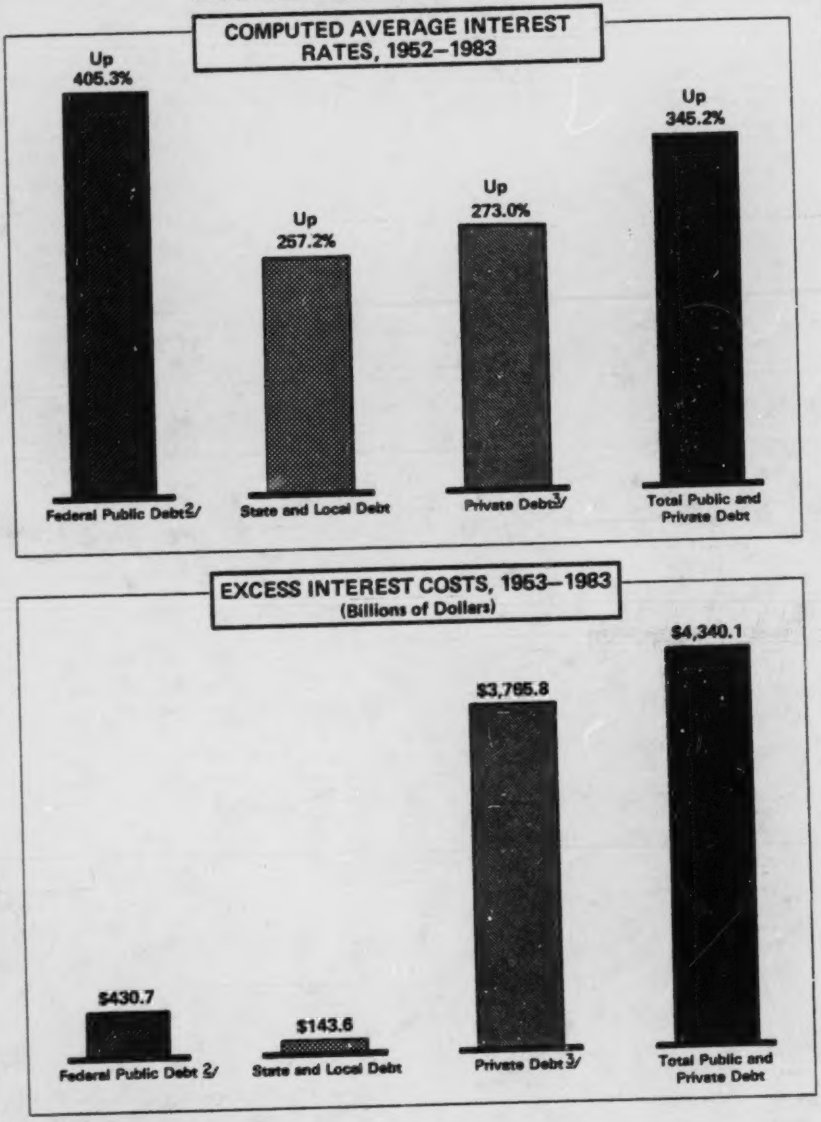
1/ 1983 estimated.

2/ Two-Three year averages used, 1976-1983, in view of frequent ups and downs.

Data: Dept. of Commerce; Dept. of Labor; Federal Reserve System.

CHART 25

INCREASES IN AVERAGE INTEREST RATES, AND EXCESS INTEREST COSTS DUE TO THESE INCREASES, 1952-1983 1/



1/ 1983 estimated.

2/ Includes net foreign interest.

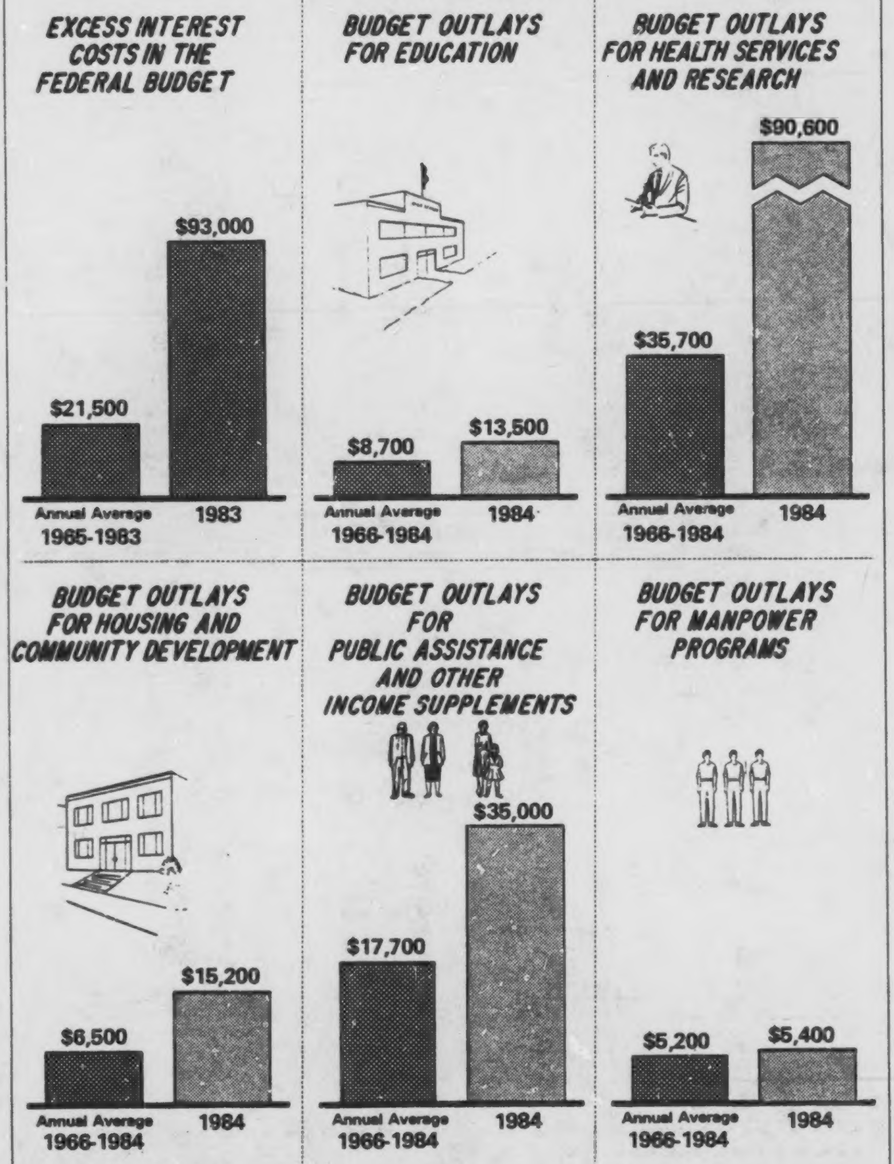
3/ Private debt series has been discounted by Government. Estimates from 1977 forward based on historical data and current trends in interest rates.

CHART 26

EXCESS INTEREST COSTS[1] IN THE FEDERAL BUDGET 1965-1983 CONTRASTED WITH OTHER OUTLAYS FOR SELECTED BUDGET PROGRAMS[2]

INTEREST COSTS, CALENDAR YEARS; OTHER OUTLAYS, FISCAL YEARS

Millions of Current Dollars

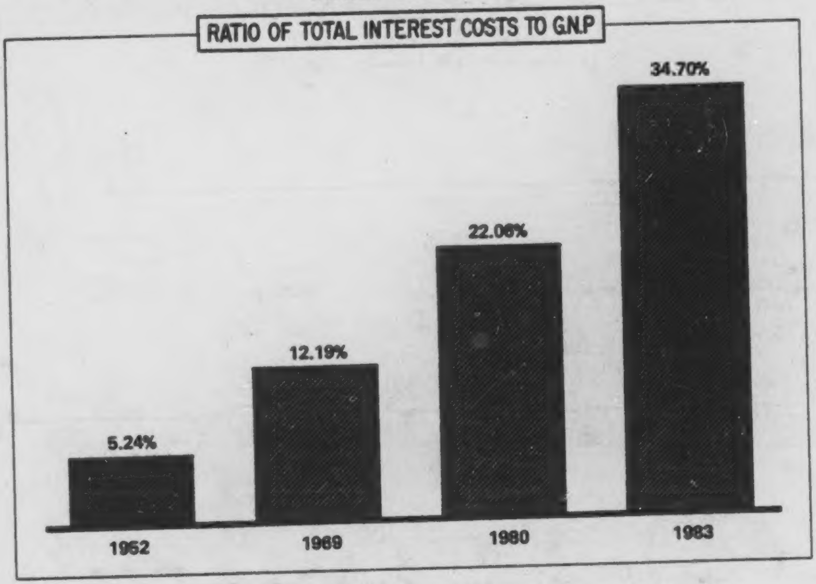


[1] 1977-1983 interest costs estimated.

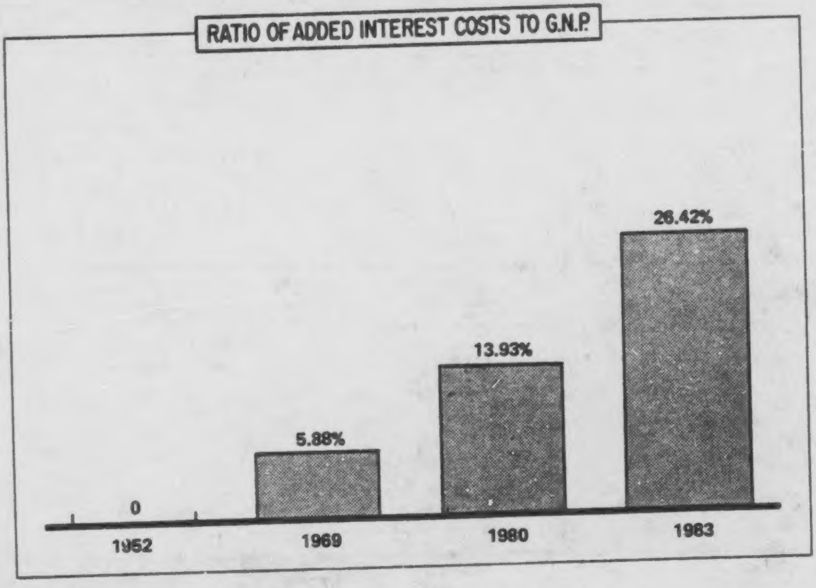
[2] As shown for fiscal 1984 in President Reagan's Budget, January 31, 1983.

CHART 27

RISING RATIO OF TOTAL[1] INTEREST COSTS AND EXCESS[2] INTEREST COSTS TO G.N.P., 1952-1983[3]



RATIO OF TOTAL INTEREST COSTS TO G.N.P



RATIO OF ADDED INTEREST COSTS TO G.N.P.

[1] Federal, State, local, and private.

[2] Additional costs due to rising interest rates since 1952.

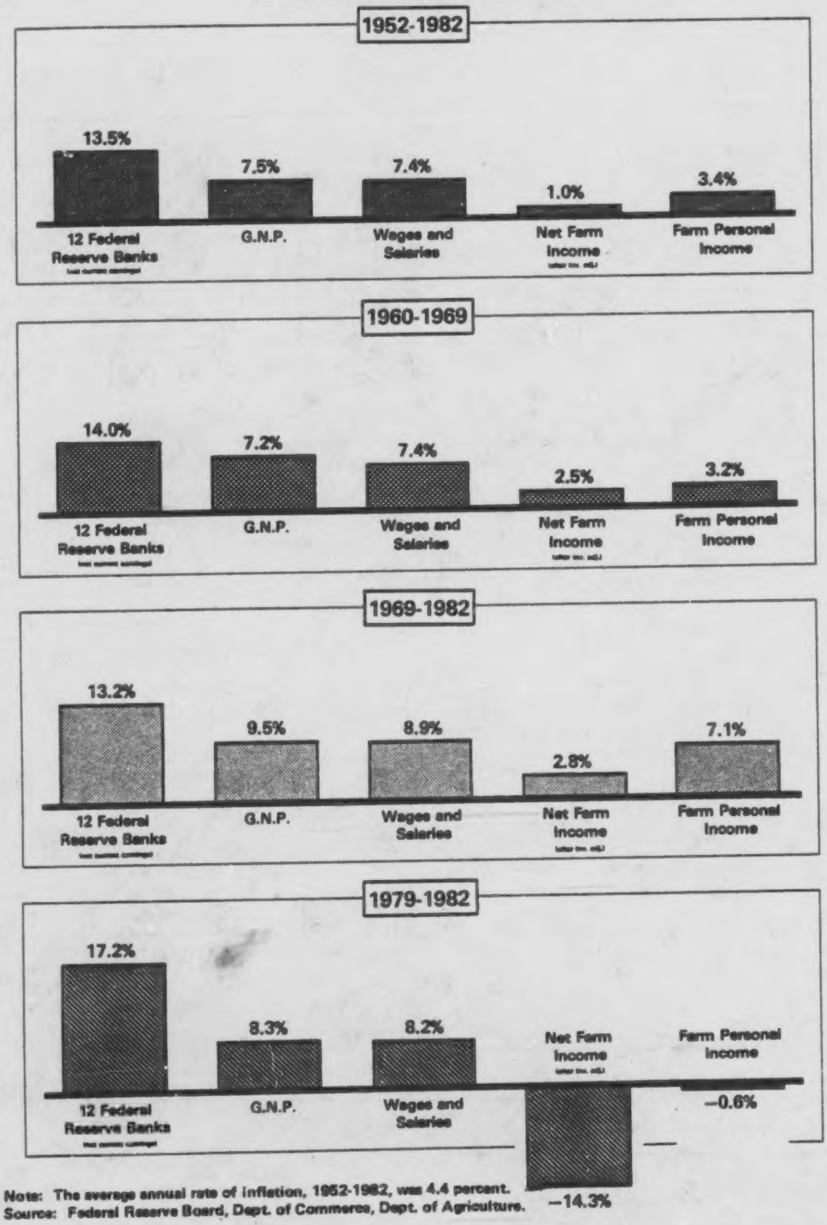
[3] 1977-1983 estimated.

Basic Data: Dept. of Commerce, Federal Reserve Board.

CHART 28

COMPARATIVE GROWTH RATES, FEDERAL RESERVE BANK EARNINGS, G.N.P., WAGES & SALARIES, & FARM INCOME, 1952-1982

(In Current Dollars, Ave. Ann. Rates)



Note: The average annual rate of inflation, 1952-1982, was 4.4 percent.
Source: Federal Reserve Board, Dept. of Commerce, Dept. of Agriculture.

REAL ECONOMIC GROWTH RATES, EMPLOYMENT & UNEMPLOYMENT, INFLATION, AND FEDERAL BUDGET CONDITIONS, DURING VARIOUS PERIODS, 1947—1983 1/

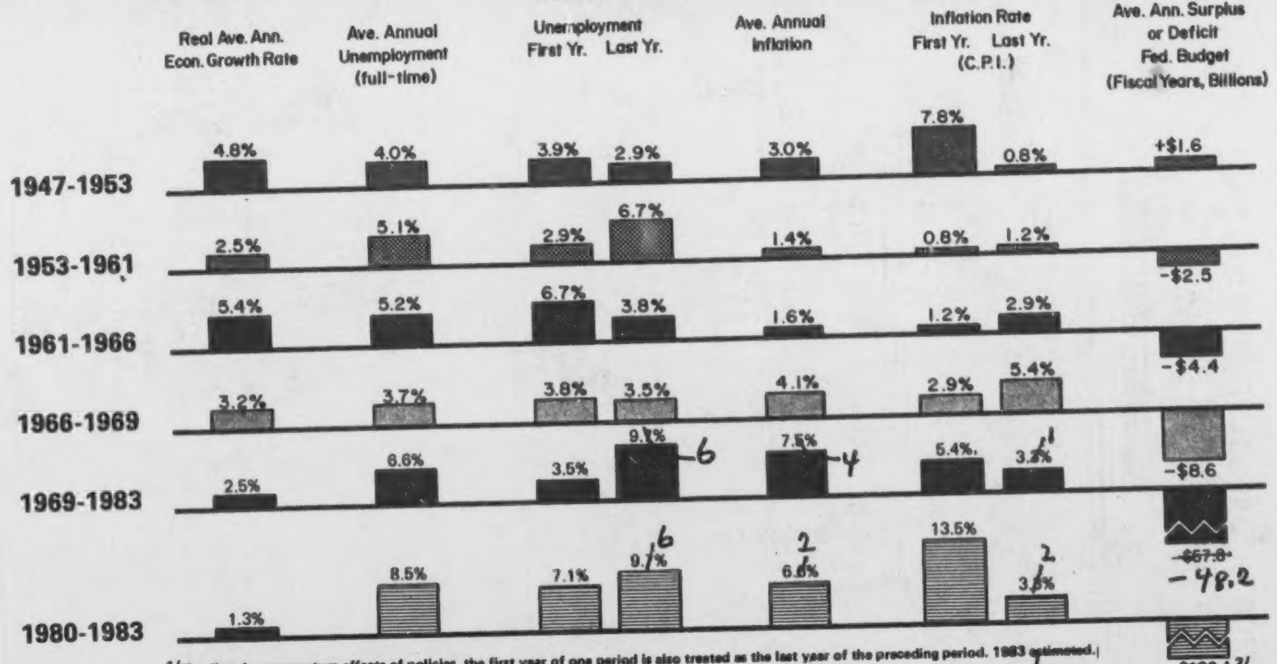


CHART ~~56~~ 29

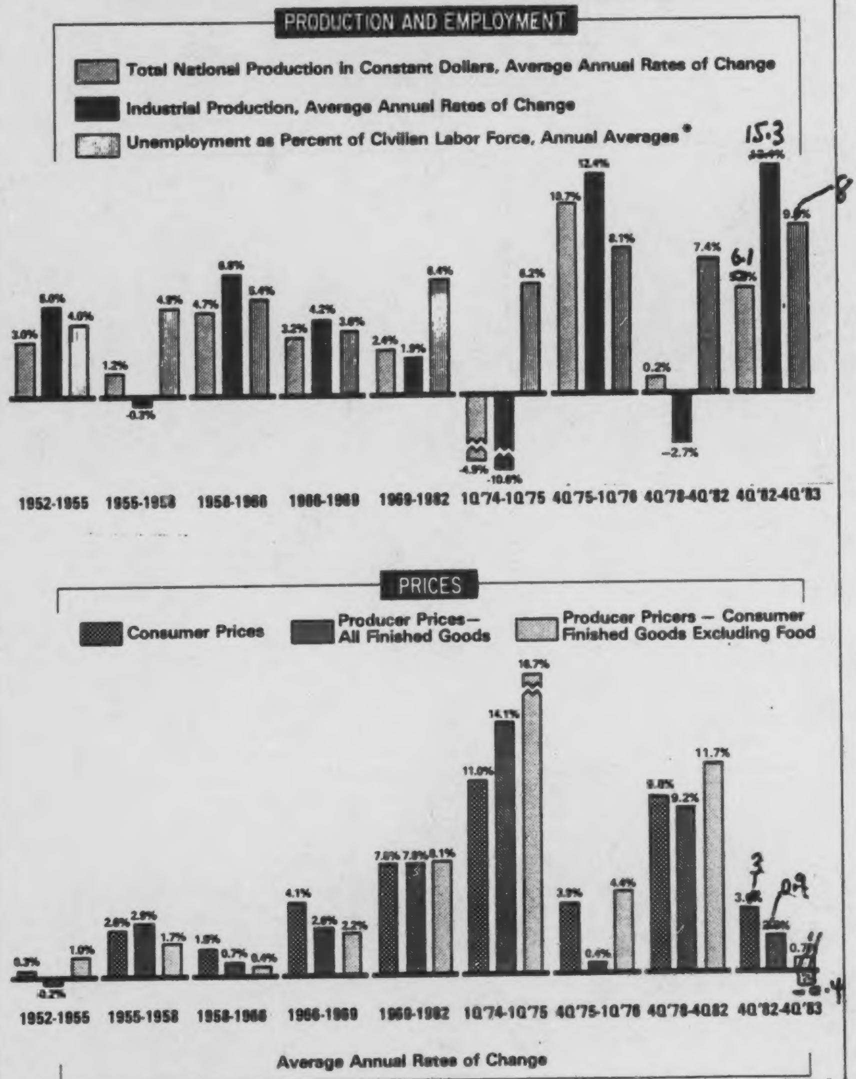
1/ To allow for momentum effects of policies, the first year of one period is also treated as the last year of the preceding period. 1983 ~~estimated~~. (Preliminary

2/ Deficit FY '83 is ~~estimated at~~ $22[illegible] billion., including off-budget Federal entity. 208

Source: Economic Reports of the President, and Economic Indicators.

CHART ~~28~~ 30

RELATIVE TRENDS IN ECONOMIC GROWTH UNEMPLOYMENT & PRICES , 1952 – 1983 1/



1/ 1983 ~~estimated~~ preliminary .

* These annual averages (as differentiated from the annual rates of change) are based on full-time officially reported unemployment measured against the officially reported Civilian Labor Force.

Source: Dept. of Labor, Dept. of Commerce, & Federal Reserve System.

Representative **Hamilton**. Thank you, Mr. Keyserling. Mr. Alperovitz.

STATEMENT OF GAR ALPEROVITZ, DIRECTOR OF THE NATIONAL CENTER FOR ECONOMIC ALTERNATIVES, WASHINGTON, D.C.

Mr. **Alperovitz**. Thank you, Mr. Vice Chairman. It is a pleasure to be here. I appreciate the opportunity. I should say at the outset that I have been advising a group of Members of the House, some 154 of whom recently signed a statement of principles. Congressmen Hawkins, Ottinger, Edgar, Vento, and others have taken the lead in this group. I am not in any way speaking on behalf of the group today. Reports along the lines of their statement will be forthcoming in the next month or two.

I also would like to say that it is a privilege to be here with Mr. Keyserling. I would like to remind the committee that under his chairmanship, the greatest successes in the American economy were registered. It is important to recognize that that period was much more turbulent, more difficult both in terms of domestic and international economic affairs, than our current, turbulent period. There is a terribly important record here that has been neglected and I think deserves to be looked at.

I will try to be brief. I would like to divide my statement into two or three parts. I talked to staff earlier about doing this from notes. I hope that that is in accord with your practice.

I think we are in a very, very uncertain period in the near term. I would begin by saying, do not believe everything you read in the newspapers or hear from administration witnesses. On its own terms, despite the latest revisions for the fourth quarter, what we have been seeing is a falling off of the rate of growth from 9.7 percent in the second quarter of 1983 to 7.6 percent in the third, to 4.5 percent in the fourth.

So the trend is very clear. There is a fading and failing of the economy. I think for most economists, the question is whether it happens before or after the election, not if it will happen.

Now, obviously, there is some dissent in some parts, but I think most economists are expecting the fading off of the economy to continue. Most now are hedging their bets by predicting 1985 rather than 1984. But that is where we really are.

I should say that, parenthetically, and particularly amongst the Democrats who have been thinking about the possibility of 1985, if we are in a fading economy in 1985, and we are faced with mounting deficits, I cannot see how either a Republican or a Democratic administration—and I am thinking now even of the possibility of a Mondale administration—will be able to slash spending and increase taxes in a fading recovery in 1985.

I think there is a conventional wisdom here which is conventionally unwise. We are likely to be in a very tight bind. And the idea that we are going to close the deficit in 1985 by those measures—which will undermine the economy in a likely period of fading—I think is an error.

So I think we have a deeper problem than the conventional wisdom suggests.

Let me suggest further that besides the fact that we are in a weakening period there are a number of time bombs that could go off. The one most discussed is whether or not there is an action by the Federal Reserve Board to raise interest rates because of either the deficit or expectations or of the temporary rise in growth. And if they respond with raising interest rates, that, itself, could give us difficulties. Everyone has commented on that. I need not go further.

A second time bomb which could undercut the economy has to do with the possibility of a severe run on the dollar. And, again, we could go into that in the question period. But if there is a run, either because the Federal Reserve Board acts as it did in October of 1979 to raise interest rates and bring back foreign-held dollars, or because the market responds, a rise in interest rates could also severely strangle the economy.

The third time bomb which has not been adequately faced, and it is sort of taken for granted, has to do with the Middle Eastern situation, particularly the Strait of Hormuz.

We are facing an escalation in the Iran-Iraq war and a situation of desperation, particularly on the part of the Iraqis, who are running out of time, running out of people, and running out of money. Their own military, by a number of estimates, have been pushing hard to use the one remaining weapon that they have in the face of large scale, mass troop assaults by the Iranians. And that one remaining weapon is an attack using the Super 8 Entendardt and the Exocet missiles on the loading facilities at Kharg.

The response could well be a closedown of the Persian Gulf. Even though some of our military people think they can sweep the gulf clear, I think Lloyds of London will close down the gulf, insurance rates will be so high. As you know, both DOE and CRS have been predicting if that happens, the price of oil could go to $100 a barrel and some of the estimates by CRS go to $300 a barrel.

That time bomb is ticking. I do not know whether we are going to hit it this year, this spring, this fall, but it will not go away. And the administration's cutback on conservation programs, its reluctance to speed up the filling of the strategic petroleum reserve, and its vetoing of a congressionally passed standby authority to establish controls in the event of a real explosion, I think have left us extraordinarily vulnerable. Our vulnerability has not been adequately discussed.

The other time bomb has to do with the price of feedgrains. We are in a situation where we have reserves in the feedgrains just sufficient to manage that system. We are talking about 600 million bushels. We should be at the range of 1.6 billion. If we have another bad crop year, either in this country or somewhere else in the world, we are going to see the price of feedgrains, and with it, the price of beef and other fed-cattle, other fed-animals, livestock, going very high.

Those time bombs are ticking away and I think could undermine an already failing projection.

In one sense, let me put it this way—we have been playing Russian roulette with this part of the economy. And if you think about the 1970's as large-scale military expenditures in the Vietnam war without a tax increase, as an oil crisis, as a food crisis, as a housing cost expansion and a health care expansion in the inflation sectors, all of those areas—and we can go into housing and health—we are again vulnerable and made more vulnerable by the policies of the Reagan administration: the military side, the weakening of the oil reserves, the PIK program, which devastated our capacity to handle a shock on the food side—we are very, very vulnerable to another scenario of shocks from inflation in these key sectors sending us down the track that we were on in the 1970's.

I think that these are factors that are not adequately appreciated and just needs to be put into the forecast. So I am very cautious about one of those randomly hitting over the next year. President Reagan had extraordinary good luck on both oil and food so far. If his luck holds, fine. But the law of chance, I think, is beginning to catch up on all of us and this could be very nasty.

Well, again, briefly, bearing in mind the time constraints, what would be the appropriate strategy both for the near-term and the long-term?

Above all, let me say I think at the outset, and here I strongly agree with Mr. Keyserling and some of the things that he has written and also the thrust of his testimony, above all we need an integrated plan, a coherent plan, not a series of disparate programs—a plan in which we begin to assess adequately the relationship between productive capacity and growing consumer and business and government demand over time. We are just not doing that.

In the near-term, and bearing in mind where we are now, how would you begin to shape out a strategic plan that might, with an alteration in administration, I would hope, begin to give us a different direction in the economy?

The first point, I think has to be what our goals are? And we really need to get a sharp focus, I think, on this 1987—1988 period—take 1987 as a good point.

The administration is projecting unemployment at the 6.8-percent level in its best forecast for 1987. I think there is an interesting underground growing concensus amongst a number of economists—Otto Eckstein, and I understand Professor Klein yesterday, and Professor Eisner as well—are beginning to talk about, and I think realistically, the feasibility of getting to 4-percent unemployment rates without engendering inflation.

Now that has been a subject that has almost been forbidden in American political discussion. Everyone has said that it is inflationary, even though I think the record disputes that. When people like Eisner, Klein, Otto Eckstein are beginning to say, look, 4 percent is a realistic possibility, I think we can begin to take it seriously and ask, what would it take if we were to aim at those kinds of goals seriously?

If we begin to sharpen that focus for 1987, what you are then saying is about a 3-percent difference in unemployment from the optimistic administration forecast. You will pick up, on a conservative estimate, $90 billion on the deficit right there. That is a terribly important fact—if you focus on the outyear goal of high levels of growth and low levels of unemployment. This outyear deficit problem begins to close down to the tune of $90 billion, whether or not you have tax reform.

I would advocate additionally for those outyears and for the short years serious tax reforms to further close and balance the budget. But I think it is important to say, look, as part of our problem, we can get a handle on it by sharpening the goals for the outyears.

Now to do that, and here is where I think my emphasis would differ from a number of economists on my side of the aisle, I think the starting point is to say, do we, in fact, have a coherent, shaped plan that can deal with the known inflationary problems built into this economy and can facilitate the transition from here to there?

So I start with how do we deal with inflation in a way that is other than further recession?

What are the elements of a plan? They are not difficult to understand, but they are not commonly in the public debate. First, we have to deal with those time bomb explosions in energy and food. And that means, above all, conservation and reserves in energy. We have to build up the reserves when we can in the feed grains. We are going to need standby controls. And I would be for standby licensing in the case of a severe shortage in grains. We need to expand the supply of housing. We need to take some action directly on the medical front.

We need to target jobs to those areas of surplus labor where there are slack labor markets so that we can begin to build for higher levels of growth without engendering inflation in the submarkets. Training programs are a key part of a coherent plan. A variety of active labor-market policies to provide jobs in those areas directly. Further R&D discussed by a number of people. Two other areas that I think are not terribly well understood:

One has to do with bottlenecks in the economy. The fact is that we have been running the economy in the last several years in a way that has been generating and building in future bottlenecks which prevent us from getting to high levels of growth.

Those who have been studying the auto industry know that we are beginning to run into severe parts shortages in certain areas and supply shortages which are beginning to undercut the capacity of that industry to generate production. That is no accident.

The reason that we are having those bottlenecks build up, and I think we are going to see it in construction if we have a fairly decent year in housing, is that we have been building expectations of low growth and low demand, so necessarily in certain sectors, there is a restriction of investment and a decaying of capacity.

That means when you begin to move to higher levels of growth, you run into built-in bottlenecks that are designed into the system.

So if we are talking about industrial policies, one focus, I think, has got to be concretely, where would we begin to invest within the comprehensive context of an overall plan to prevent those throttling future bottlenecks from shutting us down?

In a full production economy, we might even run into severe bottlenecks in certain parts of the steel industry, which is now in excess capacity. In a high-growth economy, we begin to shorten down in certain of the subsets of the steel industry. No one is paying attention to that. In fact, we are further cutting back and further hampering our capacity to grow.

So, as I said, if I were to say a major part of an interim strategy is an articulated strategy to prevent inflation, which would then permit us to move to much higher levels of growth, both economically and in the public debate.

That strategy I think has got to be sharply defined but I do not think it is that hard to outline. And I also do not think it is that hard politically. In fact, I think it is a political winner if we put it together in a coherent way.

But if that kind of a strategy is the first point of policy, we are then permitted to argue, and I think argue successfully, that a much higher level of growth is possible. It may well be if productivity follows previous trends, that even on its own terms, we could get back to the 1960 record of 4.8-percent unemployment average, 2.8-percent inflation. But with a coherent, targeted and active anti-inflation program, there is no reason that we could not get to those levels. And with those levels and with a coherent tax reform program, a sharp reduction in the deficit in the outyears would be possible.

In that context, and in the context of such a plan, you can, I think, reasonably expect a more accommodative monetary policy and an expansion in certain sectors of public investment and, finally, a shift from parts of the military budget to those areas where we are going to need targeted investment—housing being one, energy conservation being another obvious area, infrastructure being a third, training programs being a fourth, targeted job programs a fifth.

So if you are willing to deal with the inflationary problem head on in the outyears, and the outyear deficit in a really high growth economy, you can come back to a very strong argument that the Federal Reserve Board should relax if the outyear is clearly in focus.

Similarly, you are able to urge, in the near-term or as a stage 2 development in the coherent plan, an expansion of public investment and along with it, a tax increase to pay for it.

I think one of the points that has been neglected is that there is a difference in the multipliers between a tax cut and an expenditure cut. If we were spending $100 billion and taxing $100 billion more, we would decrease the deficit by the order of $18 to $20 billion because we get a better multiplier out of the expenditure side.

In the best of all possible worlds, in stage 2, I would like to see a very significant increase in public investment, both to get that multiplier in better balance and to get more stability in the growth rate. Investment could then count on a stable outyear growth path generated by a predictable expansion of public spending and investment in the areas that the economy badly needs.

I do not want to take an awful lot more time, but I do want to stress that I think there are some political elements here that ought to be dealt with in the current debate. I am shocked by the way Democrats have avoided the inflation issue. I think that there is a very strong argument that this administration has made us extraordinarily vulnerable to the kind of inflation in these key sectors that we experienced in the 1970's and that it is only a matter of time before the time bombs explode.

Along with that, I think the Democrats ought to be offering a coherent, sharply focused inflation program to permit them to shift the emphasis to a highly aggressive, full-production economy.

The other political point about this—and it may well be that the key to such a policy—is that we may not have an economic problem, we may have a political problem. The key to engendering the kind of support that we really need is offering a vision and a strategy that brings forward levels of participation and support from those who would be affected by a decently functioning economy.

A coherent policy of the kind I have outlined may well be the only way to bring forward the kind of support we need in the 1985 period to really roll into a high growth economy. They may be reciprocals of each other rather than the current view that we cannot move forward because of political constraints.

Finally, I would say, and we often do not talk about this, but I think that it is part of the economic and political problem—building a sense of fairness or community or a sense of the larger community into the core of our economic policy is absolutely central, because we are stalemated in our current economic strategies because we have not generated a vision and a politics at this point which can sustain a coherent economic policy.

I do not think that is beyond us. In fact, I would put it this way—I think that we are facing enough economic decay on its own terms. We are facing a fading recovery in the out-years, anyway. The time bombs that are ticking away are likely to disrupt the economy. And at some point along the line, it is my own hunch that there is going to be a rebuilding of a different economic and political strategy out of that pain.

So I would like us to anticipate both what makes sense economically in terms of a coherent program on inflation and stimulus, and begin to anticipate it politically so that we can build the support that we need for a thrust forward in this direction.

Obviously, there is a great deal of detail that one could go into on this, but I think it is not beyond us to begin sharpening our focus. I think the conventional wisdom about what is going to happen in 1984, and particularly 1985, if we are in a fading economy, just will not wash any further.

I do not see a chance for us using the conventional deficit remedies in 1985 as a way to solve the problem. We are going to be really in the soup if the economy is fading.

Representative **Hamilton**. Well, thank you very much. Let me just take off from where you ended. And, I guess my question to you is of a shorter range focus in time. What do you do right now?

Your proposals focused on 1985 and they assume a major political change in the country which would permit us to do the kinds of things you said ought to be done to prevent inflation and then to move to higher levels of growth.

What do we do in 1984? Forgive me for focusing on such a short timeframe, but we are faced, it seems to me, with a fairly immediate problem. We really have to accept the political realities of this current situation. What kind of advice would you have for us in the short run?

I think Mr. Keyserling said to us, if I understood him correctly at the end, that he is quite prepared to expand government programs, not to worry too much about the deficit. At least that is my impression from your comments. Loosen money policy. Increase domestic spending. Decrease defense spending. No big tax increase.

How do you focus on 1984?

Mr. **Alperovitz**. Well, again, let me say that I think we could begin in 1984 on a comprehensive strategy to require in the out-years both tax increases and reforms so that the forecast for the out-years would be sharpened and clearly defined rather than now as it is, uncertain. And we could take care of the two major areas—oil and grains. We could begin to build up our capacity so that we get further assurances that we will not have a disruptive effect in those key areas.

In that context, I think we can come back to a much more accommodative monetary policy now. I would not at this point increase taxes. And I think there is a case, although a politically difficult case—I certainly would favor it, but I think it is virtually impossible—for an expansion of public spending in certain areas, particularly given the leadtimes that we are likely to face in getting any of this stuff on the road. By the time the Congress would act on expenditures, particularly in the infrastructure area and get it rolling, we are 1 year and 1½ years down the track, about the time when I think we are going to need it most.

So my own view would be to anticipate that.

I would also like to shift the mix from military to certain parts of the public side.

Representative **Hamilton**. In any event, the focus in the short term would be trying to get an anti-inflation policy in place to ward off the so-called time bombs that you mentioned.

Mr. **Alperovitz**. That would be the heart of it. I would also implement targeting programs now to begin to focus jobs toward areas of surplus labor and higher unemployment. That is part of an anti-inflation program.

Representative **Hamilton**. Mr. Keyserling, I would like to get your reaction to his proposal here. Are you in accord with it? Where would you not be in agreement?

Mr. **Keyserling**. Well, generally speaking, I think that my friend here and I are remarkably in accord. My minor points of difference are that, first, while I said that we had to look at the long run rather than the shorter run, that is because I believe that one merges into the other and there is not much difference and that, therefore, if you set down a policy that is good in the long run, that is what you ought to start doing now.

Now coming to the political factor, I do not think that as an economist I should be debarred from advising the Congress in testimony on the ground that it may not be politically feasible. This is not impractical because if nobody ever advises anybody on what is now not practical, you will never get a change to what is necessary.

I look back at long experience at an earlier time when there were significant people in the Congress—I will not name them—who did not wait until they counted noses and had a numerical superiority.

The other thing I would say on the political front is that I honestly believe that the approach I indicated, if properly brought to the people, would sweep the country. I am still having a great deal of speaking experience before all kinds of groups. I find that there is nothing more popular than saying to a mixed group that we have to get interest rates down—not after this happens or after that happens, but now and how, and why they are so wrong, and why they are distributing income in the wrong direction and why they are magnifying the problems.

I think that sells.

I also do not think that public investment is not so unpalatable if you accompany it with a proper analysis of the real meaning of the deficit. And there I would not so much argue the point that the deficit may be desirable now, as argue the point that there is only one way to reduce it. After all, President Carter, who was no great shakes, although he was of my political party, had a deficit of $50 billion. We have run it up to $200 billion by trying to reduce it in the wrong way. If the economy grows, we take care of that.

Representative **Hamilton**. One thing that you would do right now would be to make money policy more accommodative.

Mr. **Keyserling**. Yes.

Representative **Hamilton**. Would you do that also, Mr. Alperovitz?

Mr. **Alperovitz**. Yes.

Mr. **Keyserling**. In that connection, my charts are very indicative of the complete misrepresentation of money policy. We hear that the money policy is expanding too rapidly. Well, you have really got to look at it in real terms because the money expansion that you need to float the economic ship in real terms is money policy in real terms.

Looking at it in that way, we have had a negligible or negative monetary growth in the money supply in real terms in most of the recent years. And the average annual figure shows virtually no change during 1953–83. We have had an extraordinarily tight money policy.

Representative **Hamilton**. How do you respond to the criticism that to do so is going to reignite inflation?

Mr. **Keyserling**. Because I do not think that inflation comes from policies designed to produce a higher real performance of the economy. I think it comes from the reverse.

Now it is interesting that Mr. Feldstein—I ascribe it to him—on the last pages of the 1983 Report of the Council, where he has this incredibly jumbled and mixed-up discussion of the Humphrey-Hawkins Act—I have never quite seen anything like it, going in all directions—he admits on two pages that recent experience has indicated that you can have more inflation and more unemployment at the same time.

Well, he ought to have admitted that long ago because that is how the term "stagflation" got coined. The trouble is that the policymakers and the economists coined the term, but pay no attention to it. They act just as they were taught in the books 50 or 60 or 80 years ago, that if you have 10 apples and more buyers, you will have more inflation.

Mr. **Alperovitz**. I would like to address that question, too. I think on its own terms, the argument that making a more accommodative monetary policy in these circumstances is inflationary is a very weak argument. The best studies I have seen are by Professor Gordon at Northwestern and Professor Friedman at Harvard; but Jamie Galbraith of your committee staff has also done excellent work in this area.

It is very hard to make a strong argument that the money supply itself throughout the decade of the 1970's is the key to inflation. But you do have to address the specific inflation issues, which is what I am saying.

If you look back at the period of the 1960's, as I said, we are on the average at 4.8-percent unemployment and 2.8-percent inflation. Throughout the 1960's, that was the average.

The inflationary problems of this last decade are very, very definable. They are not excess production. They are not the money supply. They are very deeply sectoral—energy shock, food, the military budget, Vietnam, health care, housing problems, interest rates adding to the cost of production. And you can pick that apart and I think there is very little disagreement when you really get down to these sectoral problems.

So, conversely, to the degree we address those specific problems, the language I like is to prevent another 1970's, and to the extent that we, in that context, get a higher growth rate and a sustained growth rate so that our productivity returns on a sustainable level, we are really addressing the inflation problem.

But I think we have to mount that case both economically and politically. We have to get over this argument that it is the money supply or the deficit that are causing the inflation. The latter has been subject to rigorous attack with the deficit tripling or quadrupling and the inflation rate going down. We just know that is just nonsense.

Nonetheless, we have not yet offered an alternative to both public and private perception that is sharply focused enough to allow us to mount a serious program.

Representative HAMILTON. Congressman Hawkins.

Representative HAWKINS. Mr. Alperovitz, on the question of the target for 1987 that you mentioned, you mentioned a group of them and, in effect, you said these should be some of our primary objectives at this time—you mentioned conservation, as I recall, housing, medical care costs, research, food policy, dealing with the bottlenecks, and so on—all of these, in effect, although you call them investments, do imply expenditures.

To that extent, I assume you come very close to what Mr. Keyserling had said about actually increasing some domestic spending.

Now, that obviously, politically, is the other extreme to what the President, over national television, is saying, that it is spending, although he does not identify it between domestic and defense spending, that is the cause of our current difficulties. And I think that also comes very close to being the mood of the Congress as well in accepting that formulation of what actually is the cause, what are the causes of our current difficulties.

How would you respond, therefore, to this charge which politically says, well, there is a group who advocate spending. It is the old policy. It is what got us into our current troubles and so forth. And, therefore, do you believe that it is a practical approach at this time to rearranging the economy?

Mr. Alperovitz. That is a political question as to how one could do it now rather than an economic question, I take it.

Representative **Hawkins.** Well, how would you, in economic terms, let us say, explain why it is so necessary to spend money, let us say, on housing or medical care or the other things which are needed? Would it be cost effective? Would it in some way deal also with the inflation issue, the inflation charge, that this spending is inflationary, or this spending adds to the deficit and so forth; therefore, it is not, from an economic point of view, leaving out all the other aspects of it, that from an economic point of view, that it is not at this time contributory to getting the economy back into shape?

Mr. Alperovitz. I think one can reasonably make the argument, because I think it is true. We will be badly burned if we do not mount this argument, if we do not address some of these key areas, and particularly, the bottlenecks, they are going to cost money. The Reagan administration is slowing the filling of the strategic reserve because of the deficit problem.

I do not think that it is hard to explain to the public. I have had the same experience that Mr. Keyserling has, that this is just penny-wise and pound-foolish, that it is stupid to allow us to be this vulnerable when everyone knows the Middle East is a wild card game that could explode at any time. It is not hard to explain that we ought to be going after real energy conservation and strategic petroleum reserves. And that is an investment, an insurance policy for the future.

You know, when I go out to the public, people do not find that inflation has gone down. We read it in the papers. We economists know it. Members of Congress know it. But a popular experience is that inflation continues and it is a very troubling problem, particularly in the grocery stores and food markets. They experience price rises still going on. And the polls demonstrate that it is still very important.

Doing something in the food area, health costs, expanding the supply of the HMO services—I do not think that those are difficult to sell, both on their own terms and also in terms of really going after these areas that could be disastrous and create another 1970's.

I think in the near term, the argument that we ought to strategically shift a part of the military budget to these areas is an argument that I think many people are increasingly open to.

I would go further: we ought to expand in some areas now, given the leadtime problems, getting some of these things onstream in infrastructure and some of the training and the R&D. And I also find, and this is really quite interesting—I talk to people or speak to various groups out in the country and there is a strong sense of just what we economists are saying: the vast majority sense that the recovery is not likely to last.

I find that people understand that. They think that this thing will probably collapse sometime after the election, which I think is economically right.

The argument that we are going to have to prevent that and get some leadtime investments out there now because it takes so long to get things onstream is a reasonable argument.

Now I think the President would do well to attack this. But if we begin to see a fading in the economy before November, it may well be that being prepared on these two fronts—the investments needed to prevent an inflation explosion and the investments we are going to need for stimulus—there could come a moment even this year where we begin to say, how do we make sure that this thing is sustained.

I do want to emphasize that as to 1985, most of my colleagues in the economics profession are worrying about the deficits that are going to be taken care of. And what that means is tax increases. And that is a very common conventional wisdom.

I think that that is absolutely ignorant of what is going to happen if the economy is fading. If we are in the beginnings of another deep recession in 1985, nobody is going to raise taxes and cut spending.

So we have got this problem with us, whether we like it or not, and I think strategies along the lines that we are talking about are going to be necessary, not going to be nice. They are going to be the only way to get this ship rolling again if we begin to fade.

So I think this business about the outyear deficit, which is so commonly discussed, is just not in accord with what we are likely to face.

Representative HAMILTON. May I interrupt there?

Representative HAWKINS. Sure.

Representative HAMILTON. Suppose that happens. Suppose you do have a fading economy in early 1985. That means that your deficit grows much more rapidly than is projected because all of the projections of the administration and the Congressional Budget Office assume a fairly decent growth rate.

Mr. ALPEROVITZ. That is right.

Representative HAMILTON. So you are going to be facing deficits of considerably greater proportion than now projected.

Mr. ALPEROVITZ. That is what I think is going to happen, yes.

Representative HAMILTON. Yes, OK. What do you do then? You say a tax increase would be the wrong thing.

Mr. ALPEROVITZ. That is right.

Representative HAMILTON. But I presume that you would loosen money policy and I presume that you would go ahead with additional spending programs, which will further jack up the deficit.

Mr. ALPEROVITZ. That is right.

Representative HAMILTON. And you are talking about horrendous deficits.

Mr. ALPEROVITZ. What I am saying, Congressman, is that I think it will be interesting. We will meet again about a year from now, or a year or a half from now—I think that we are in a situation, as outlined, that we are likely to see just that result. I do not think that politics is going to permit a real resolution on the deficit and I think that the growth rate is going to fade and, just as Mr. Keyserling said, if that happens, the source of the deficit is the failing economy, primarily, plus the tax cuts. Just the context that you are outlining is likely to face us.

In that moment, not now because the political debate is different, people are going to say, what are our options? Can we raise taxes? That will not fly. That will further deepen the recession.

Can we cut spending? That will not fly. Will the Federal Reserve Board actually accommodate a growth policy in the face of expanding deficits? No, not on the current terms. Yet, the economy is deepening into crisis.

I am saying that at that point, there will be no option but to do what we are talking about. And I would like to see us prepare right now, for how to get the economy rolling.

Representative HAMILTON. I see. Are we "Whistling Dixie," then, if we promise the people that we are going to cut the deficit by 50 percent in the next term?

Mr. ALPEROVITZ. In the current discussion?

Representative HAMILTON. Beginning in 1985.

Mr. ALPEROVITZ. Yes, I think we are, given my forecast.

Representative HAMILTON. Then we ought to tell them that.

Mr. ALPEROVITZ. I think so, and along with that, that the recovery will not last and therefore, we have a worse problem than we have been talking about. And I think that many people understand that when they really look at it, economists and many people on the Hill. When they really look at what we are saying, this is not hard to understand, that we are in a very nasty position, that the public discussion is not facing it.

Representative HAMILTON. Well, I like your emphasis on—excuse me here, Congressman Hawkins. I am taking your time.

Representative HAWKINS. Go right ahead.

Representative HAMILTON. I like your emphasis on trying to get an anti-inflation program in place. I think that that makes all kinds of sense, because it does give you some protection when you move ahead to the second part.

Excuse me, Congressman Hawkins. Go ahead.

Mr. ALPEROVITZ. It is the only way to do that.

Representative HAWKINS. Let me ask about that. I got the impression, and I think we certainly agree that we should have an anti-inflation program, and if the administration has one now, it is tight money as a means of fighting inflation. But you outline, I think, one that was much broader.

But did I get the impression that you would make that the first step in what you describe as stages? That was somewhat confusing to me, whether or not you were saying that now we are going to deal with inflation. We have to have an anti-inflation program, and that is given the primary consideration.

Would you clarify that because you did speak of an integrated and coherent plan. And then when you began to deal with some of the sections, it seems that you were breaking it again into, you were fragmenting it, which you had previously criticized.

Mr. ALPEROVITZ. Absolutely. I emphasize inflation—the coherent and sectoral inflation problem because we have not been talking about it so much. The heart of it is that we cannot move forward unless we put together an integrated plan. If we take care of these inflation problems in a really hard-headed, specific, concrete way, simultaneously we are able to deal with the monetary policy and the stimulative policy. We get into the crossroads on either money policy or spending policy when we have not the other piece.

So the essence of it is to put a plan into an integrated bill or an integrated form so that the pieces operate together. Different parts of it have to hit different years.

Representative HAWKINS. I understand it better. The administration people who have come before this committee since the issuance of the economic report have dealt with growth in terms of you cannot have the type of growth that some of you are suggesting to reduce unemployment and to do the other things to meet the national needs and so forth because of the fear of inflation.

And they have not presented an anti-inflation program. My understanding is what you are saying is that this should be presented in connection with the growth so that we can get the adequate growth that we need to do the things that you think need to be done, and it is in conjunction with an anti-inflation program.

They seem to jump to the conclusion that anybody who talks about reducing unemployment or promoting growth, that that individual is not assuming that you deal with inflation.

Mr. ALPEROVITZ. That is right.

Representative HAWKINS. And, consequently, that shortsighted description that they have, I think, gets them into the difficulties we are now in. The way I get it, you are talking about a coherent or an integrated approach.

Mr. ALPEROVITZ. They have won the argument economically and politically by default. Because we have not addressed these elements of the inflation problem, what they can say is cut the budget and have a recession. Or we need tight money. But I think the elements you need to bring forward to break through are the ones I outlined.

I would like to make one further comment on the social and political aspects of this, Mr. Hawkins, Mr. Hamilton. It is this:

Around the world, in the advanced industrial nations, and I think this is a moral issue as well as a political issue, rightwing governments, and we have a rightwing government, have used the inflation issue systematically to attack labor, the poor and races, either by creating a recession, attacking labor settlements, or attacking budgets for the low-income people.

In this country, in this particular advanced industrial country where the labor force is so split along racial grounds, that is a recipe for racial violence.

Now the answer to that, in my opinion, has got to be a coherent, integrated, anti-inflation argument that does not require either massive attacks on labor, recession, or attacks on the poor and minority groups. So it is a moral issue as well as an economic and political issue to put forward an alternative to this really vicious policy that is endemic around the world.

So I see inflation as terribly important, both on the economics and the politics of it.

Representative HAWKINS. Yes, that suggests another argument that is used, and that is, and Mr. Keyserling, I would like to address this to you. Statements have been made recently, as late as yesterday, about the unemployment, interim unemployment target in the Full Employment and Balanced Growth Act. And we hear quite extensively 6 and 7 percent being used as the rate of unemployment that has become a new target. I do not know by whom or who advocates this because, obviously, nobody has suggested amending the law itself which set the interim target of 4 percent.

And there are many individuals who actually doubt that 4 percent is realistic or that in fixing that target, those of us who promoted the passage of the Full Employment and Balanced Growth Act were somehow treated with kindness. We just stuck in—that no one at that time or no one since that time believes that it is even achievable.

Now in view of the fact that you participated in that 4 years of debate and committee hearings and the other steps leading up to the passage of the act, do you consider that the 4 percent, merely as an interim target, was a realistic target, that it is still a realistic target?

I think you indicated yourself that in previous administrations where individuals believed in achieving that target, it was achieved with price stability, so that, to some extent, already answers the question.

But how would you rate the realistic possibility of having an economy that can get us down to that target?

Mr. KEYSERLING. Well, but realistically, again, I am talking, and they are talking, about what is economically feasible because they do not say that the goal is too low because it is politically non feasible. They say it is too low because it would be inflationary.

Now the first answer to that, and I think that the goal is more vindicated by experience and need today than it was 4 years ago. I do not think there has been anything to refute it. In the first place, the economists ought to ask themselves, how did we get unemployment down to 1 percent during World War II?

Now, they will say superficially, well, the war did that. The war does not do anything. The Vietnam war was very poorly managed economically and unemployment rose. We got unemployment down to 1 percent because we believed that for the purposes of production and employment, albeit, for different usages from now, 1-percent unemployment was economically sounder than the 13-percent unemployment or whatever it was that we had even at the start of the recovery from the Great Depression.

The mature position leads to the conclusion that it is always better to have lower unemployment. Now, then, again, during the time that I served with Truman, when we got unemployment down to 2.9 percent, we had a President who, when asked when is unemployment too high, his answer was, it depends on whether or not you are unemployed.

And this is not a quickie answer nor a political answer. This is a fundamental recognition of what we are talking about. We are talking about human beings and what the society is doing to them. And the repercussions of that.

What is going to happen eventually if 45 percent of the black youth remain unemployed? They are going to become adults. What are their attitudes going to be? What is their motivation going to be? What is their training going to be? It is most foreboding.

Coming to the strategy on the inflation, first of all, let me say that I agree entirely with Gar here that we should take all these steps to fight inflation he suggests. But I think it is also important to tell the public, at least in my judgment, that these are not the main causes of inflation. We had a serious and chronic increase in inflationary trends long before these specific difficulties existed in acute form.

Now I say, let us take care of all basic causes. But the main causes of inflation are neglected. The most weighty cause of inflation is the very excessive unemployment of plant and manpower which we accept or augment in the name of fighting inflation.

Now let me give the two reasons why that is so, which is supported by all the empirical data on my charts.

In the first place, we do not have a competitive economy in the old-fashioned sense, or in the Adam Smith "Invisible Hand" sense. We have an economy where prices are made by the decisions of managers. And it is really amazing that, while 30 to 40 years ago economists talked about imperfect competition and explained why business did not behave, or rather, prices did not behave in accord with the appleseller story, that awakening is hardly present now.

Now big business, and I have studied this industry by industry and I do not say it by way of indictment, but by way of description—they have a profit target. And when their sales are less satisfactory, they increase their prices per unit to reach their target. This is one very important thing. It has happened all along and it is not noticed.

The second thing is productivity. Now most of the talk about productivity indicates that we have low productivity because of the cost of protecting people from lung dust and all kinds of other things except the real thing.

When you have a plant where the optimum operation is 92 percent of capacity and it goes down to below 70 percent, that is a percentage of drop very much greater than the percentage drop in the number of workers retained in the plant.

When that happens, since the productivity figure is not describing technological trends which are still racing ahead, but is describing merely the division of the labor input into the output, the result is that the productivity figure goes way down. And then prices are increased to pay for that increased business cost per unit of output.

I have examined this in all the big industries all the way through and I show in my charts, even back in the second and third quarter, 1983, or in earlier periods, where we had even for a short time a very large and exciting increase in the rate of real economic growth, and productivity growth rate shot way up. And now, when the economic growth rate is dwindling, the productivity growth rate goes down.

So the main attack, as for all the things suggested here, the main attack upon inflation—inflation is the measure of a sick and weak and ineffectual economy—the main attack is to get the economy performing at higher levels.

It necessarily follows from this that beginning now because we are 15 years late, 10 years late, 5 years late, in addition to the integrated, rounded program which Mr. Alperovitz so properly suggests to reduce inflation, we must move on the front of getting the economy to operate better, as the foremost means to restrain inflation. And just as you need these aggregate measures that I indicate to restrain inflation, as well as the specific measures, so on the growth front you need macroeconomic or pointed measures as well as microeconomic or general fiscal and monetary measures.

I think you have to start with a program, not with a series of conflicting programs.

Mr. **Alperovitz**. I would like to add just one footnote.

As to the feasibility, in your question of 4-percent unemployment, there was a hearing conducted by this committee in 1972. I think Senator Proxmire was in the chair, on the feasibility of 2-percent unemployment. And you will find in that record, Mr. Feldstein and Mr. Stein arguing absolutely certainly we could have a 2-percent unemployment rate without inflation.

It would be wonderful to bring back some of that testimony.

Representative **Hawkins**. Well, back in 1976, in a letter which I would ask be made a part of the record——

Representative **Hamilton**. Without objection.

[The letter referred to follows:]

CONGRESSIONAL BUDGET OFFICE

APR. 2 2 1976

Honorable Augustus F. Hawkins
House Committee on Education and
Labor
Subcommittee on Manpower, Compensation, and Health and Safety
United States House of Representatives
Washington, D.C. 20515

Dear Congressman:

Attached you will find our answers to the questions you raised in your letter of April 1 concerning H.R. 50, the "Full Employment and Balanced Growth Act of 1976."

We very much appreciated having the opportunity to respond to your questions and, if we can be of further assistance, please do not hesitate to let me know.

With best wishes,

Sincerely,

s/
Alice M. Rivlin
Director

cc: Alice M. Rivlin
Intergovernmental Relations
de Leeuw
Barrett
File

PREPARED BY: FA: Nancy Barrett and Frank de Leeuw:bjs: 51438

Attachment: Wage-Price Model Paper

Correspondence Control No. 342

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FA	Barrett TSB	4/20						

RESPONSE TO QUESTIONS SUBMITTED BY
REPRESENTATIVE AUGUSTUS F. HAWKINS

Congressional Budget Office

April, 1976

1. What real economic growth rate, and what increases in employment would you project, consistent with the objective of reducing unemployment to 3 percent by the end of calendar 1980? What quantitative and qualitative differences do you find between such projections and projections or extrapolations of the real growth rates and employment trends through 1980 under current national policies and programs in being?

To bring unemployment down from the 1976:I level of 7.6 percent to 3.0 percent by the fourth quarter of 1980 would require a sustained average annual rate of real economic growth on the order of 7 percent. Employment would have to rise by about 3.6 percent each year.

In comparison, an extrapolation of the real economic growth rates and employment trends through 1980 under a current policy budget might be expected to leave unemployment in the 5.0 to 5.5 percent range by the fourth quarter of 1980. This estimate is based on an assumed growth in real output averaging 5.5 percent per year and an average annual growth in employment of 2.9 percent.

2. How much value do you attach to these differences, measured against your evaluation of resultant differences in inflationary pressures?

One function of the Congressional Budget Office is to analyze possible outcomes of alternative fiscal policies, including the potential impact on employment, unemployment, economic growth, and inflation. We do not, however, take a position on the value of these outcomes.

We can note, however, that the faster growth path does, by the fourth quarter of 1980, result in about 4 million more jobs, a 2.0 to 2.5 percentage points reduction in the unemployment rate, and a level of real output about 7 percent greater than for the path extrapolated from a current policy budget. The faster growth option might, however, add from 2 to 3 percentage points to the Consumer Price Index by 1981 and from 3 to 5 percentage points by 1984, assuming no supplementary anti-inflation measures were adopted. If the anti-inflation measures proposed in H.R. 50 are adopted, price increases might be less than these estimates. (See the answer to Question (10).)

3. What specific techniques are used in making the Congressional Budget Office estimates as to future variations in inflation rates, based upon assumed variations in real GNP growth rates and in levels of employment and unemployment? To what extent have you used actual correlations between these variations since 1947, on an empirical basis in arriving at your forecasts for the future? Have forecasts to date by highly regarded economists, with respect to inflation, been accurate enough to promote confidence in such forecasts now? What are such experts as Arthur Burns and Alan Greenspan now saying as to the validity of the "trade-off?"

The Congressional Budget Office uses a variety of techniques to evaluate the potential macroeconomic impact of fiscal policy alternatives. Econometric models are available from such private organizations as Chase Econometrics, Data Resources Incorporated, and Wharton Econometric Forecasting Associates. Other forecasters frequently make their results available to us. In some cases, "consensus" estimates from these sources are developed and combined with judgmental evaluations by CBO staff economists.

One tool for assessing the potential inflation impact of achieving alternative unemployment rates through aggregate demand policies is a simplified wage-price model developed by CBO staff. It is a two-equation model in which there is a lagged mutual interdependence between wages and prices. Price changes depend upon this year's and last year's wage change, to food price changes and to fuel price changes. Wage changes depend on the unemployment rate and current and past price changes.

There are two versions of the model: an "accelerationist" variant and a "long-run Phillips curve" variant. The difference between the two is the difference between a 70 percent and a 100 percent reflection of past inflation in current wage settlements.

The model is estimated from annual data from 1953 through 1974. The source of the data is the Bureau of Labor Statistics of the U.S. Department of Labor.

Forecasts of inflation in recent years have been exceptionally difficult because of the sizeable inflationary influence of unpredictable events like higher fuel and energy prices. When inflation occurs as a result of exogeneous shocks, statistical models based on past wage-price interactions will not predict very well.

Further, some people believe that the nature of the wage-price interaction process itself has changed in recent years. This change is attributed to a number of influences such as increased inflationary expectations, changed demographic structure of the labor force, or increased market power of business firms and labor unions. Much of the controversy about the changing structure of the inflationary process centers on the question of whether there is a long-run trade-off between inflation and unemployment. Some economists--for example, Arthur Burns, Alan Greenspan, and Leon Keyserling--have made statements in the past reflecting the view that there is no tradeoff. The two versions of CBO's wage-price model reflect different points of view on this question.

4. If your forecasts as to variations in rates of inflation under various growth rate and unemployment assumptions rely on econometric models and computers, will not the results be erroneous, if the structure of the models or computers are not supported by the empirical evidence as to how prices have actually behaved under varied rates of real economic growth and unemployment? What do the models and computers add, beyond what can be developed by reasoned examination of the empirical evidence by competent economists?

Models and computers can deal with certain logical complexities beyond the capability of an individual working unaided. But models and computers are highly fallible tools for economic forecasting, and their widespread use has not noticeably improved the accuracy of forecasts.

5. The "trade-off" theory is generally viewed as holding, not only that a vigorous movement toward full employment is inflationary, but also that unemployment held below given levels is higly inflationary. In fact, the latter is the more widespread view. If you hold that view, how can we ever have sustained full employment, if we regard it as unacceptably inflationary, at least in the absence of permanent direct controls, which certainly are not feasible now, and I believe unnecessary now? Viewing these considerations, what do you regard permanently as the optimum level of unemployment--3 percent or what higher figure?

Most economists would agree that there is some rate of unemployment, both of capital and labor, below which significant inflation usually develops. But there is considerable disagreement over the rate considered inflationary. In terms of the labor market, most would place the critical level above 3 percent of the labor force at the present time. However, most would also agree that measures to reduce structural imbalances in the labor market, to improve labor mobility, to reduce frequent occurrences of unemployment among the unskilled, and to improve employability by training and the elimination of discrimination could lower the unemployment rate at which the labor market becomes "tight." If such measures were adopted and were effective, a non-inflationary unemployment rate could potentially be even lower than 3 percent.

6. In your inflation projections, what studies have you made of administered prices, which operate independently of unemployment rates? Is it not true that, reviewing the entire price record since 1947, administered price increases, in general, have been much more rapid during periods of high and/or rising uhemployment than during periods of low and/or falling unemployment?

The Congressional Budget Office has not made any studies of administered prices to date. However, there is some evidence that industries where market power exists show more stable price patterns than in more competitive industries. This would mean less downward flexibility in periods of falling demand for "administered" as compared with "competitive" prices, and conversely, less upward movement in periods of rising demand. The Council on Wage and Price Stability has made a number of studies of administered prices recently. In general, they find that industrial concentration does tend to reduce price flexibility over the cycle, but that there are many exceptions both for particular industries and for particular cycles.

7. What Federal Budget outlays through 1980 do you regard as consistent with arriving at 3 percent unemployment by the end of calendar 1980, taking into account inter alia the policies and programs specified in H.R. 50? What are your projections of Budget outlays through 1960, assuming projection or extrapolation of outlay trends under current policies and programs? What is the estimated difference between these two projections, and how do these compare with the GNP and employment projections referred to under (1) above? How do these two Budget projections compare with the recent Budget recommendations of the majority of the Joint Economic Committee and what appear to by your recent implications as to preferable Budget policies?

The answer to this question is highly complex, involving a careful assessment of the potential strength of private demands between now and 1980. We are currently analyzing this issue as part of a study requested by the Joint Economic Committee of S. 50 which we expect to finish sometime in May. We will make that analysis available to you then.

8. What savings or offsets against these Budget outlay differentials would you estimate to result from the Hawkins-Humphrey proposals and the respective operations of the economy under the alternative projections?

Savings or offsets against budget outlays are reduced transfer payments like unemployment insurance, food stamps, veterans payments, AFDC, social security and the like that result from higher levels of employment and income. Increased tax receipts associated with higher incomes also offset the effect of higher outlays on the deficit. Offsets will be higher to the extent jobs programs are targeted at persons formerly receiving income transfers. One-half or more of an original increase in outlays might be recouped through higher tax payments and reduced transfers. A more detailed estimate of these offsets will be made in the forthcoming study for the Joint Economic Committee.

9. What would be the effects upon the Federal deficit of the alternative projections, taking proper account of compensating offsets referred to in (8) above? What weight do you attach, under conditions of severe economic slack, to the size of the Federal deficits as they bear upon the process of inflation?

Like Question (7), the answer to this question will involve a careful evaluation of the potential strength of the private economy between now and 1980. Consequently, we will address it as part of the forthcoming study of S. 50 for the Joint Economic Committee.

10. How do you evaluate the effects of specific anti-inflationary measures in H.R. 50, and other portions of H.R. 50, as these effects compare with estimated inflationary pressures in the absence of H.R. 50 and these specific anti-inflationary measures?

Supplementary measures to reduce potential inflationary pressures both during the recovery period and in the full-employment economy envisioned in H.R. 50 could hold down price increases. Their effect might work both through reducing inflationary expectations as well as by mitigating some of the underlying economic forces that contribute to price increases. Materials costs might be reduced by some of the measures suggested; and a weakening of the market power of monopolies might result in somewhat lower prices if profit margins are reduced thereby. (See, however, the answer the Question (6) in which it is noted that competitive prices may be more volatile cyclically than monopoly prices.) Increasing productivity in the private sector could be advantageous, particularly if unskilled workers are to be drawn into private sector jobs at relatively high wages.

While the effects of such measures would seem to work in the direction of reducing inflation, it is difficult to analyze how great that effect would be without more detail as to the specific policies envisioned. Further, while it is likely that such measures would result in less inflation at 3 percent unemployment than if no anti-inflation program were adopted, it is not possible to conclude that the inflation rate under these circumstances would be more or less than if a slower-recovery strategy and/or a high long-run unemployment rate target were adopted.

11. If H.R. 50 were enacted, would you favor immediate imposition of direct controls, to what extent, and why and for how long? In this connection, I refer again to my question (5).

The role of the Congressional Budget Office is to analyze possible outcomes of alternatives, not to recommend or support particular policies. The evidence as to the effectiveness of direct controls on inflation, particularly over the long run, is mixed, and opinions vary as to their past or potential ability to stabilize prices. CBO has not done a formal study of the possible costs and benefits of direct controls, nor has such a study been requested.

Representative **Hawkins** [continuing]. Alice Rivlin, who was then the Director of the Congressional Budget Office, said that most would also agree that measures to reduce structural imbalances in the labor market to improve labor mobility, to reduce frequent occurrences of unemployment among the unskilled, and to improve employability by training and the elimination of discrimination, could lower the unemployment rate at which the labor market becomes tight.

If such measures were adopted and were effected, a noninflationary unemployment rate could potentially be even lower than 3 percent.

I think that is very indicative of what the thinking was at that time. These are the things that we are not doing now to reduce unemployment and to meet the inflation argument. Consequently, I think that that is very indicative of why we accepted a 4 percent, but merely as an interim goal rather than the 5 or 6 percent.

But I think the explanation is more political than it is economic, that at 6 or 7 percent, you have a lot of individuals competing for too few jobs. And, therefore, you can reduce wages. You can certainly break the back of organized labor in its negotiations. And you can certainly, because at that rate, you have whites, male whites, perhaps, doing better than female whites and you certainly have blacks with a very high unemployment rate, Hispanics, and other groups.

And so what you do, you get political dissension among the groups that ordinarily would form a coalition to do something politically. And so that is the reason you have certain individuals before this committee suggesting 6 and 7 percent unemployment. It is not just a matter of recognizing what is factual, but it is also a policy, a deliberate policy, in order to attack wages and to politically disorganize individuals, which is precisely what is happening. And I think you should add that to another time bomb that you speak of.

Representative **Hamilton**. On final question. Mr. Keyserling, who prepares your charts? Do you prepare all those?

Mr. **Keyserling**. Yes; I have to prepare them because you cannot ask an artist to prepare what should be in the charts. I use a commercial artist only to reproduce in prettier form exactly what I set down on paper.

Representative **Hamilton**. Well, they are very good.

Mr. **Keyserling**. I mean with the help of other economists.

Representative **Hamilton**. They are very good. I am quite impressed by them. To those of us like myself who are not economists, they certainly clarify things.

We have appreciated both of your testimonies today. It is excellent. Thank you.

Mr. **Alperovitz**. Thank you.

Representative **Hamilton**. The committee is recessed.

[Whereupon, at 11:45 a.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 28, 1984.]

THE 1984 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 28, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. Parren J. Mitchell (member of the committee) presiding.

Present: Representatives Mitchell and Hawkins.

Also present: James K. Galbraith, deputy director; and Paul B. Manchester and Robert R. Davis, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE MITCHELL, PRESIDING

Representative MITCHELL. Good morning. Our hearing will now come to order. The vice chairman, Congressman Hamilton, unfortunately ran into a conflict of some significance and he cannot be with us at the opening of this hearing. It is possible he will join us later.

We also expect that other members of the committee will appear during the course of the hearing.

Last month the Consumer Price Index rose at an annual rate of more than 7 percent. Grocery store prices rose about 2.4 percent in the month of January. Food prices were affected last month by not only the drought of last summer but the winter freeze, and the overall cost of living is rising much faster than 6 months ago. The chart indicates that prices have accelerated more than usual at this stage of the business cycle.

Inflation is currently running at a rate of about 5 percent. The administration believes that the CPI will rise by 4.5 percent this year, and then will decelerate to a rate of 3.5 percent by 1989.

In light of the huge deficits in the President's budget, most of us in Congress—and I certainly am one of them—just do not believe this will happen, or if it does happen it means there will be a significant change in the Federal Reserve's monetary policy—exceedingly tight money, which obviously means higher interest rates. And that obviously would suggest a recession in the next few years.

To lower the risk of much higher inflation and ease the pressures on the Federal Reserve, we, the Members of Congress, must act decisively this year to reduce these unprecedented deficits.

Let me say, as one Member of the Congress, I am unalterably opposed to any further cuts of magnitude in domestic programs. They have been savagely cut. Mr. Stockman at OMB has indicated that he sees no further room for cutting domestic programs, which are essential to so many millions of our people. Obviously, my inclination is for a substantial cut in the Defense Department's budget, which is almost totally out of hand. Despite the fact that this is an election year, I think we must do something about increasing the revenues coming into our government.

The third year of the tax cut, as everyone knows, helped to produce this enormous deficit, and we ought to address that problem with courage and speed.

Our witnesses this morning—and we thank you for being here with us—will give us their views about inflation in the next few years and some guidance as to how we can avoid a surge in prices.

The witnesses are Mr. Lawrence Chimerine, chairman and chief economist at Chase Econometrics; Mr. Kudlow is not here as yet, I do not believe; and Mr. Geoffrey Moore, director, Center for International Business Cycle Research at Columbia University.

Gentlemen, thank you very much for being here. It is just so difficult to take time out of your busy schedules. On the other hand, contrary to popular opinion, the Members of Congress are not omniscient in their knowledge, and we do need help and guidance from you.

With that, I will ask Mr. Chimerine to lead off. We have a copy of your prepared statement, Mr. Chimerine.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS, BALA CYNWYD, PA.

Mr. CHIMERINE. Thank you very much, Congressman. I am delighted to be here. And I would request, by the way, that my prepared statement be submitted for the record.

Representative MITCHELL. Without objection your prepared statement will be inserted in its entirety into the record.

Mr. CHIMERINE. Since it is a rather lengthy statement, I would like to summarize it as briefly as possible, with particular emphasis on the issues you raised in your letter requesting this testimony. Those issues are, first, the short- and long-term outlook for the economy in general; second, the deficit issue—how bad deficits will be and what can be done about them; and third, the impact of future economic performance and deficits on both the short- and long-term inflation situation and inflation outlook.

I would like to begin with a very quick summary of where we see the general economy for the rest of 1984, and then, from a long-term perspective, what kind of economic growth we can expect for the rest of the decade.

As you know, the recovery process is now a little more than 1 year old. It has been a rather average recovery in most respects, but very welcome because of the long period of economic stagnation that preceded it. Most economic statistics indicate that, on balance, this recovery is relatively typical of those experienced previously in the postwar period in the United States.

I think the most important characteristic of the recovery process thus far is the fact that it has very strong underpinnings and that it has been caused principally by factors which are not cyclical in nature but seem to be somewhat more permanent—I should not use "permanent" in the long-term sense, but certainly they are permanent enough to suggest that we are likely to see a continuation of this recovery process through the rest of 1984.

This does not mean that the current economy has reached a healthy stage; nor will it be completely healthy by the end of this year. All it suggests is that the process of recovering from the rather depressed level of economic activity that existed when the recovery process began is continuing and will continue. Moreover, it is hoped that if it were to continue for a number of years, we would get back to a relatively fully employed, prosperous economy.

What are some of the factors that will contribute to continued recovery during the rest of 1984?

First of all, I think the factors that have been responsible for the surge in consumer spending, which has probably been the principal ingredient in the recovery thus far, continue to be favorable. These include relatively modest inflation so far; rising real incomes for most Americans, at least for those Americans who have not lost their jobs; a favorable debt situation; and a sharp decline in the actual debt burden in recent years. Now consumers appear to be willing to add to that debt, and they have a great deal of leeway to do so.

Confidence is very high; certainly higher than it has been at any time during the last 10 years or so, at least. Primarily, I think this reflects a better feeling about the future on the part of most people, particularly with respect to their own jobs. Compare the situation now with 1982, when confidence was very low. That lack of confidence primarily reflected a concern that many people had at that time that they were going to be the next to be laid off. That mindset does not put one in the mood to spend, even if one has an income. That has changed significantly as a result of an improved attitude about job security.

Finally, even with the recent decline in the stock market and the bond market, most people who own stocks and bonds are somewhat better off, in many cases considerably better off than they were 2 or 3 years ago.

So, on balance, the underlying financial condition of most American families is much better than it was in previous years. They have more ability to spend, and they are more willing to spend. And, of course, many pent-up needs were created during that long period of stagnation; this is a very favorable combination. We see these forces continuing, and they are likely to result in additional increases in consumer spending during the course of 1984.

Second, the indicators for investment are better now than they have been for several years. Order rates are up significantly from a year or so ago. Even business construction, which has been very depressed, seems to have picked up from the low point. Currently, as a matter of fact, we are going to see a little bit of activity for industrial plants and store construction, which had been extremely depressed for several years. Plant and equipment surveys and appropriation levels also indicate a favorable outlook for investment in 1984.

Exports, which have dragged down the recovery so far and prevented it from being an even more buoyant recovery, are probably bottoming out now. In fact, many of our clients are telling me that, for the first time in 2 years or so, they have seen a slight improvement in their export orders. It will not be spectacular, but this is a lot better than the sharp declines we have had in recent years.

State and local governments are in a much better financial condition now in general than they have been in several years and are beginning to spend those funds principally for infrastructure-related kinds of projects—highway repair, maintenance, and so on.

Inventories are extremely low. With the possible exception of a few metals, farm equipment, and a few other industries like that, they are very low throughout the economy. There is very little risk of any cutback in economic activity resulting from inventory liquidation. Quite the contrary, it is very likely that we will see some modest additional inventory rebuilding.

Finally, while I think most of the recovery is over, we will not experience as much growth in housing this year as we saw last year. Nonetheless, all the leading indicators, such as housing starts, housing sales, the increased use of variable rate mortgages, builder buy-downs, and increases in the number of households, suggest that the housing sector will also hold up reasonably well during 1984.

Altogether, this suggests a very high probability of continued growth for the rest of this year, although the rate of growth will moderate from 1983 principally because the impact of inventory shifts and housing on economic activity, growth, and production will be less this year than it was in 1983.

With respect to the long-term outlook, I have a number of concerns. What is the potential for economic growth in the long term, even assuming we have appropriate policies and we return to full employment by the end of the decade? In particular, I would like to make reference to the most recent administration forecast, which underlies recent budget projections. As you may know, that forecast calls for average real growth of approximately 4 percent per year for the rest of the decade. I think that, even under the best of circumstances, that is extremely optimistic. Most likely, the best we can expect for economic growth for the remainder of the decade is somewhere between 3.0 and 3.5 percent a year. Moreover, if we do not address the deficit issue, I think we will fall considerably short of that as well. Thus, I think that the prospects for longer term growth are not as optimistic as some recent forecasts, particularly the administration's forecasts, would suggest.

There are a number of reasons for this.

First of all, that forecast, as well as many others, assumes relatively rapid growth in the labor force during the rest of the decade—not quite as rapid as in the 1970's, but nonetheless still relatively strong. I do not think that this is likely to be the case; in fact, we have already begun to see labor force growth slow dramatically, even though we are early in the recovery process when, generally speaking, the labor force tends to accelerate.

There are a number of factors holding down the growth in the labor force. One of them is slower growth in the working-age population. Another one is the divorce rate, which has peaked out and seems to be exerting less upward pressure on the female participation rate. Finally, I think some of growth in the number of females in the labor force in the 1970's reflected a squeeze on household purchasing power, and then high unemployment, which encouraged a lot of wives to enter the labor force to perhaps supplement family income and replace some lost family income. With a stonger economic performance and lower inflation, I think that, too, is resulting in less upward movement in the female participation rate. Combining these factors, I do not think that we will see the labor force grow at more than 1.0 or 1.5 percent per year during the rest of the decade. Many of the forecasters were in the 2-percent range.

Second, productivity growth is a key factor in the long-term outlook, both for the economy in general, and for inflation—we will get to that in a moment. I think we have seen some numbers lately that are quite disturbing. Let me briefly review what has happened during the last year or two.

Productivity growth decelerated sharply during the 1970's, ultimately reaching an underlying trend rate that is about zero. But then we had a big pickup in productivity in late 1982 and 1983, and this led many people to assume that we have seen a major improvement in the underlying trend in productivity. I think we have seen some improvement, but in the last 6 months or so, the growth in productivity has slowed dramatically, particularly when compared with comparable periods in previous recoveries. In fact, for the first year of an economic recovery, we had considerably slower productivity growth, again compared with other recoveries. This suggests to me that we not only had the normal cyclical impact in 1983, but we also, in the early part of the year, were getting the largely one-time impact of all the cost cutting that took place in the economy during 1982 and 1983. While there is some cost cutting that will feed through the next year or two, I think a lot of it had a one-time impact. Excluding that and and the normal cyclical factor, it looks like the underlying trend growth in productivity may only now be 1.0 to 1.5 percent a year, not the 2 percent or more that other people were hoping for, and certainly not the 3 percent year we had in the 1950's and 1960's.

Looking at recent numbers, productivity growth fell to 1 percent in the fourth quarter, and, based on partial information for the first quarter, it looks like we will see a relatively small increase again. The recent evidence seems to be consistent with that, even though we had a big surge in manufacturing output in 1983, which, of course, should have pushed overall productivity upward. As we move back to more services and a smaller mix with manufacturing, this factor will have less of an upward impact on productivity during the next several years.

Finally, I think there is probably less slack in the economy now than some people might have expected, even though we are only 1 year into the economic recovery. Utilization rates are rising in many industries in part because a lot of previous capacity has been eliminated or is too inefficient to use. Even though we still have very high unemployment, the ratio of employment to the population is still fairly high. There is a mismatch between industries where we need capacity, which are relatively tight, and those where we have a great deal of excess capacity, but these are not going to be the growth industries in the 1980's.

Combining all these factors, relatively slow growth and potential output, and the fact we do not have that much slack to begin with—there is some, but not an extremely large amount—even if we reach full employment by the end of the decade, our best judgment is that economic growth will not average more than 3 to 3.5 percent per year. Of course, this is well below the administration's forecast and obviously suggests that the administration's calculations for the deficit are very much on the low side. In fact, I think the deficit outlook is much closer to the CBO projections than the administration's projections. In any case, I think that the long-term economic outlook is not quite yet as favorable as some other forecasts would suggest.

What about inflation, and what about the likely effect of these deficits? I should mention very briefly that, in my judgment, if the deficit outlook is not changed significantly, we will not even achieve that relatively modest rate of average real growth during the rest of the decade. Average growth will be considerably less because we will see considerably higher interest rates in the next several years, which, at a minimum, will reduce economic growth even further by holding down available capacity and the growth in productivity because investment will be adversely affected. In fact, the situation may worsen, producing another recession during the next several years, which would also have the effect of reducing the long-term growth rate.

What about the outlook for inflation? Well, I think it is relatively mixed. With the exception of food prices, I do not believe that we are going to see too much of a surge in inflation during 1984. There is some modest acceleration underway, and that process will continue for the rest of this year, mostly in the food area, and I think the reasons for that are well known. A combination of the PIK program and the drought last summer caused meat producers to increase their supplies at that time, but, of course, this means reduced supplies of meat during 1984.

The winter freeze has made the situation considerably worse, not only in terms of meat supplies, because obviously a lot of cattle died or did not grow to normal weight, but, on top of that, we are already beginning to see upward pressure on citrus fruits and vegetable prices as a result of the freeze. So food prices, which are already starting to rise, will be higher. They accounted for a significant portion of the CPI increase last month, and that process will continue during 1984.

Looking outside of food, particularly industrial prices, in our judgment, there will be very little acceleration, at least during most of 1984, primarily because the economy is still extremely competitive.

I think there are three reasons for this: First, even though utilization rates are rising in the United States, the economic recovery outside the United States has lagged behind. Thus, on a worldwide basis, there is still considerable excess capacity in many industries. Second, deregulation in some industries, particularly parts of transportation, obviously have made them more competitive. Third, and perhaps most important is the impact of the overvalued dollar, which is making it extremely difficult, in some cases absolutely impossible, for many U.S. producers to raise prices. As a result, we do not see any major acceleration in inflation outside of food prices during the course of 1984. Even wage increases, which have bottomed out, are not likely to accelerate sharply because of relatively small cost-of-living adjustments because of last year's small rise in the CPI; still high unemployment; obviously, deregulation in some industries; and the fact that many companies are still intent on cost control. Therefore, I do not think that we will see a major acceleration in wages this year to push up inflation. Further, assuming nothing worse happens with Iran and Iraq, the underlying demand for oil, even with the cold weather we had earlier this winter, is still growing very slowly at best, and, again, barring a supply interruption, there is very little prospect for any significant increases in oil prices in 1984.

On balance, we still believe that the inflation rate will average about 5 percent this year, with whatever acceleration we get mostly in the food area.

The long-term outlook is considerably less favorable, for two key reasons: First, productivity. If we only get an average of 1 or 1.5 percent per year in productivity on a long-term basis, this will likely mean somewhat higher growth in unit labor cost than we have had in recent years, especially since, at some point, we will begin to see additional upward pressure on wages. The main reasons for this are the strong increases in profits that are now taking place, and, while it will not happen today, later this year, and as we move into 1985, we will begin to see unions and labor in general trying to increase wages in response to those increases in profits.

Second, sometime down the road, perhaps in 2 or 3 years, we are likely to begin to see some modest increases in oil prices again. Third, and most important in my judgment, we will eventually see a significant correction in the value of the dollar on foreign exchange markets. It is bound to happen eventually. We may already be seeing the initiation of it, but I do not think we can be certain yet. I would not underestimate the impact of a sharp decline in the value of the dollar on future inflation, not only by raising import prices, but also by eliminating or reducing some of the pressure that is holding down industrial prices in the United States. In addition, even though profits have improved significantly, profit margins are still low. Companies are going to take every opportunity they can in the years ahead to rebuild margins further.

Finally, dollar-denominated commodity prices are still unsustainably low. Those industries are losing money, and eventually, a decline in the value of the dollar will push those commodity prices higher as well.

All of these factors will mean that inflation will probably average 6 percent for the rest of the decade. On the deficit issue, potentially, the prospect of future deficits could make it significantly worse, particularly if the Fed tends to accommodate or monetize those deficits. Because of the increased sensitivity of government spending and future deficits to interest rates and the fact that higher interest rates make spending and the deficit considerably worse, it is not difficult to envision a great deal of pressure on the Federal Reserve in the years ahead to prevent higher interest rates. To do so, they might have to let money growth continue at a very rapid rate. While that would not bother me too much in the short term, if that were to occur over a long period of time, I think it is clear that it would cause additional inflation during the rest of the decade.

Thus, I think that, longer term, the inflation outlook is not particularly bright. To put it another way, I think we have already seen the best news on inflation in the United States that we are likely to see for the rest of this decade.

What about economic policy and what can we do to prevent even worse inflation, or maybe even hold it below the 6 percent rate for the rest of the decade?

Very briefly, I think priority number one is to get the deficits down. We need sufficient spending cuts and tax increases to produce a downward trend to future deficits, using appropriate economic assumptions or realistic assumptions, a trend by which the deficit will fall by something like $30 billion, at least, each year from the preceding year. This does not mean $30 billion below the current projection because that would still leave us up near $300 billion by the end of the decade. I think we need a downward trend to get us below $100 billion by the end of the decade.

That will require substantial spending cuts or tax increases. In my own view, I would agree with you, Mr. Chairman, that spending cuts should at least not be in the discretionary social programs, the means-tested programs. I think we do have to address entitlements. The growth in entitlements has to be slowed considerably, I believe, by raising the retirement age for social security more quickly than is now scheduled, and by scaling back the COLA formula for social security and for other entitlement programs. I think the defense buildup should be stretched out. But even after we do all this on the spending side, in my judgment, there will still exist a need for significant tax increases in the years ahead relative to those that are currently scheduled or currently legislated.

I think the deficit could potentially produce even faster inflation because it will crowd out investment in the long term, which will reduce growth in capacity and, at the same time, further reduce the growth in productivity. From a long-term standpoint, even if we avoid another recession, it is likely to make the long-term inflationary outlook worse.

I think policies that would encourage more exploration for oil, possibly even some tax increases on energy to reduce demand, to prevent the possibility of another massive oil price explosion in the years ahead, should be considered.

In terms of other measures to stimulate more capital spending, I believe we need more tax incentives for research and development. We need national standards for education to encourage more mathematics and science.

I am no great fan of indexing throughout the economy. Quite frankly, if we could eliminate it constitutionally—I do not know if we can or not, but if indexing could be eliminated for Government spending and particularly on the wage side—I think we could go a long way toward preventing the possibility of another severe wage-price spiral, such as we had during the 1970's. This inevitably develops any time we have an outside force starting the inflation process. This begins with a surge in food prices or oil prices, and then the higher wages, causing the whole process to accelerate. I think we should be considering moving to either 1-year collective bargaining or eliminating COLA.

These are some of the additional policies I believe should be considered in addition to policies designed to reduce future deficits.

Thank you, Congressman.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine, and I am Chairman and Chief Economist of Chase Econometrics. I appreciate the opportunity to testify before the Subcommittee on Economic Goals and Intergovernment Policy of the Joint Economic Committee. I will focus my remarks today on the short- and long-term outlook for economic growth and inflation.

SUMMARY

In brief, my views are as follows:

1. The outlook remains favorable for continued economic recovery during the course of 1984, although at a more moderate rate than during 1983. Economic growth this year will be fueled by additional gains in consumer spending, resulting from rising real incomes, an increased willingness and ability to borrow, and high confidence levels; by a rebound in capital spending, especially for most types of business equipment; by increased expenditures by state and local governments, as well as an acceleration in defense spending; by further, although modest, gains in new housing construction; and by a modest turnaround in U.S. exports.

2. The Administration's forecast of more than 4 percent average real growth for the remainder of the decade appears highly optimistic, even with appropriate economic policies. This reflects the likelihood that the growth in potential output will be very modest in the years ahead because of relatively slow growth in both the labor force and productivity, and because the current degree of slack in the economy is not very substantial. Thus, average annual growth of between 3 and 3-1/2 percent appears to be the maximum that can occur between now and the end of the decade, even assuming the economy reaches full employment by the end of this period.

3. It is highly likely that current economic policies will also prevent the economy from growing rapidly during the remainder of the decade. In particular, the prospect of enormous Federal deficits will at a minimum further reduce long-term potential growth by holding down investment (and thereby available capacity and productivity growth); even worse, these large deficits are likely to cause a significant increase in interest rates during the next several years, leading to another recession.

4. The short-term inflation outlook remains favorable. Food prices will rise because of the drought last summer, the PIK program, and the recent winter freeze.

5. The longer-term outlook for inflation is less favorable, however, with a modest acceleration to a 6 percent average rate likely during the second half of the decade. This reflects a number of factors, principally the likelihood that the U.S. dollar will decline sharply during the years ahead and the expectation that productivity growth, while better than during the 1970s, will still be well below the levels experienced during the 1950s and 1960s. Furthermore, large deficits will inject an inflationary bias into the economy that could cause even higher long-term inflation.

6. In addition to reductions in expenditures and increases in taxes to substantially reduce future deficits, several micro policies can help improve the long-term

inflation outlook. These would include actions to stimulate research and development; to reduce the length of union contracts in the economy; and to ensure adequate supplies of energy.

THE SHORT-TERM ECONOMIC OUTLOOK

After relatively weak economic statistics for December generated concerns that the recovery was petering out, the mood has quickly shifted in the other direction—the strong January data are now being cited as evidence that the economy is growing too rapidly. However, economic statistics always become more volatile as recoveries mature; furthermore, this recovery has been highly erratic, even from its start. The erratic movements in the monthly statistics have recently been intensified by less reliable seasonal adjustment factors due to the long period of stop-and-go economic stagnation, to special factors such as the timing of financial market deregulation and innovation, and to the unusual weather patterns during the last year.

In fact, much of the January data appears to overstate the degree of strength in the economy: (a) The large 2.2 percent increase in retail sales in large part reflects an adjustment for the relatively small increase in December. In particular, the department store sales component was reported to be up by 5.5 percent on a seasonally adjusted basis, after a reported decline in December—neither appears to reflect the true underlying trend. Furthermore, auto sales will probably taper off somewhat after the relatively large increase in the last two months. (b) The relatively large 1.1 percent increase in industrial production reflected the sharp 0.4 hour increase in the average workweek (data for man-hours from the payroll survey are used to estimate various components of the Industrial Production Index). However, it is unlikely that the sharp jump in the average workweek will be repeated—a partial reversal will probably take place in the months ahead. Furthermore, even with the pickup in January, industrial production has risen by an average of less than 0.7 percent in the last three months, well below the rate of increase in the earlier stages of the recovery. (c) The 1.1 percent increase in personal income was in part attributable to the increases in government pay and Social Security benefits that went into effect on January 1, to large increases in government subsidy payments to farmers, and to the effect of the large increase in the average workweek on wage and salary payments. These relatively temporary factors more than offset the impact of the rise in Social Security taxes, also on January 1. Personal income will therefore probably rise more slowly in the months ahead.

Thus, the data for any individual month should not be used to measure either current or expected growth in the economy—the focus should be on average patterns, and whether they are consistent with the underlying forces that determine economic performance. We continue to believe that the recovery will continue during the remainder of 1984, but at a more moderate rate: (1) The major factors underlying the upward trend in consumer spending, such as rising real incomes, the willingness and ability to borrow more heavily, and increased confidence regarding future economic and job prospects, remain in place. However, while the uptrend in consumer spending will continue, the increase on a fourth-quarter to fourth-quarter basis will moderate to 4.2 percent from last year's 5.2 percent increase. This reflects the somewhat slower rate of increase in real incomes expected in 1984 because of slightly higher inflation (especially food prices), the absence of additional tax cuts, and slower growth in employment. Furthermore, the saving rate dropped during 1983 (especially in the first half)—we expect the saving rate to be flat or up slightly during the course of 1984, especially in view of the recent decline in the stock market. (2) The outlook for a substantial pickup in investment remains favorable based on recent patterns for orders, new contracts, and appropriations. Increased orders and expenditures for business equipment are spreading beyond computers, autos, and trucks, which accounted for most of the rise in equipment spending in the second half of 1983—a modest turnaround will also occur in various components of nonresidential construction, especially plant and commercial construction. (3) The improved fiscal condition of many state and local governments will begin to permit increased expenditures on the backlog of highway maintenance, repair and construction projects, and other public works projects, that has developed in recent years. Coupled with the acceleration in military expenditures, this will inject sizable stimulus from the public sector, even in the absence of major tax cuts in 1984. (4) Recent indicators (especially housing sales and starts) remain favorable for some additional growth in housing and related industries in 1984, although the major portion of the rebound in response to previous declines in interest rates has already occurred. (5) Inventories remain extremely low in most industries, both in absolute terms and relative to sales, suggesting some modest additional rebuilding of stocks. While this will lead to higher production, the effect of inventory movements on output growth will be considerably less during 1984 than in 1983.

On balance, while continued recovery is highly probable for the rest of this year, fueled by improved capital spending, increased expenditures by state and local governments, and even a modest improvement in exports, slower growth in consumer spending, housing, and inventory investment will lead to moderation of economic growth during the course of 1984. We continue to expect a fourth-quarter to fourth quarter increase in real GNP of approximately 4 percent—this forecast has remained relatively unchanged in recent months, despite the sharp swings in the monthly data.

Prior to the stronger January statistics, concerns that the recovery might peter out shortly were also being fueled by the slowdown in growth of the money supply during the second half of 1983. However, short-term movements in the basic money supply have been heavily distorted by deposit shifts, caused principally by the availability of new types of accounts. This can best be seen in the behavior of M1 velocity—it is unlikely that velocity dropped as sharply in the first half of 1983 and rose as sharply in the second half as the data suggest. Thus, the slowdown in money growth in the second half of the year simply reflects an offset to the sharp increases during late 1982 and the first half of 1983. Over the period as a whole, money growth has been adequate to finance continued economic growth (see **Figure** 1). In fact, by virtually all measures, the increase in the money supply during 1983 in nominal and real terms exceeded increases during the first year prior to economic recoveries. In addition, the recent revisions in the money supply data indicate a sharper increase during the second half of the year than was previously estimated (5.7 percent vs. 3.7 percent). A relatively accommodative monetary policy can also be seen by the relatively stable and substantial growth in the monetary base during the course of 1983 (see **Figure** 2), and by the acceleration in money growth in early 1984.

The sharp decline in the stock market in recent weeks has created additional concerns about the sustainability of the economic recovery. The decline in the market appears to reflect three factors that will not prevent continued recovery this year. (a) Following the near 60 percent increase in operating profits in 1983 (on a fourth-quarter to fourth-quarter basis), profit growth will drop sharply during 1984. This reflects the smaller increase anticipated for real output; the sharp slowdown in productivity growth in the fourth quarter (another relatively small increase is likely in the current quarter) and the resulting acceleration in unit labor cost growth; and the (extremely competitive conditions in many industries and the overvalued dollar, which are preventing companies from raising prices sufficiently to further rebuild profit margins. (b) It is now increasingly likely that significant declines in interest rates will not occur during 1984.

This reflects the upward pressure on credit demand that is now developing as a result of continued economic growth, as well as the high probability that the Federal Reserve will not ease in view of the favorable economic statistics; the upward revision in the money supply for the second half of 1983; the relatively large increase in the money supply in January; and the Fed's concern that any easing would reduce pressure on the Administration and the Congress to take action to curtail future budget deficits. This outlook for interest rates is consistent with our recent forecasts of little or no declines in rates during the first half of 1984, followed by higher rates later in the year and in early 1985. (c) The outlook for the Federal deficit remains as bleak as ever, even with the faster-than-expected recovery during 1983. The stock market is becoming increasingly concerned that there does not appear to be a credible plan to reduce future deficits before potentially adverse effects on interest rates and the economy begin to emerge. The decline in the market will nonetheless contribute toward a slower recovery process by reducing household net worth and probably by slowing the rise in consumer spending. However, since the stock market is only one of many factors that impacts consumer confidence and net worth, its effect is likely to be modest as long as the other factors remain favorable.

LONG-TERM ECONOMIC OUTLOOK

While the near-term outlook is thus relatively favorable, the longer-term economic outlook is far more uncertain. **First,** recent developments suggest that potential long-term output, even under ideal economic policies and assuming full employment by the end of the decade, is considerably less than is implied in the most recent Administration long-term forecast, primarily because of the likelihood of relatively slow growth in both the labor force and productivity. **Second,** the amount of slack currently in the economy is also less than previously had been thought. Thus, the maximum possible for average real growth during the remainder of the decade is probably between 3.0 and 3.5 percent per year, significantly less than the more than 4 percent currently being assumed by the Administration. Furthermore, in my view, it is highly unlikely that even more modest rates of growth will be achieved on a consistent basis with current economic policies, especially the bleak outlook for the Federal deficit.

Labor Force Growth

The growth in the labor force slowed dramatically in 1983 (see **Figure** 3), even though labor force growth generally tends to accelerate during the first year of economic recoveries. Many forecasts of substantial long-term economic growth are in part based on the assumption that the civilian labor force will continue to grow rapidly during the 1980s, following the average 2.5 percent per year increase during the 1970s. However, it is possible that the recent performance is the start of a new period during which labor force growth will be far more moderate. This reflects: (a) The growth in the adult population during the remainder of this decade will be far less (.9 percent per year) than the near 2 percent rate of increase during the 1970s, primarily reflecting the fact that the big bulge in the labor force caused by the baby boom is now over. (b) The divorce rate has fallen during the past year for the first time since the 1950s. Shifting demographics and other factors suggest that while, the downtrend may not continue, it is unlikely that the divorce rate will rise as it did during the prior 20 years. This would likely cause a significant slowdown in the female participation rate. (c) Rising real incomes and lower unemployment may also cause the female participation rate to rise much more slowly than during the 1970s, when a large number of women entered the labor force either because of the squeeze on family purchasing power caused by accelerating inflation or because of rising layoffs.

As a result of these factors, I believe that labor force growth of slightly more than 1.0 to 1.5 percent per year is a more realistic assumption for the remainder of the decade than the near 2 percent increase implicit in other forecasts.

Productivity Growth

The growth in productivity has moderated significantly during the past two quarters (see **Figure 4**)—partial data suggest that the rise in productivity in the current quarter will be in line with the relatively small 1 percent increase experienced in the fourth quarter. This is in mark contrast to the sharp increases in productivity during early 1983, which gave rise to the belief that a significant improvement in the underlying trend performance had actually developed. However, it is becoming more likely that the previous bulge in productivity not only reflected the normal cyclical improvement that takes place early in economic recoveries, but also the largely one-time impact of recent cost-cutting actions. In fact, even with this emphasis on efficiency, the increase in productivity during the first year of this recovery was far below those experienced in previous recoveries (see **Table 1**). The long-term outlook for productivity will also be held down by the fact that many of the people who were laid off in recent years were the least efficient and experienced—these are likely to be those rehired if the economic recovery continues. In addition, 1983 was characterized by a sharp increase in manufacturing output in relation to the increase in total GNP, which bolstered overall productivity because of the differential in productivity levels between manufacturing and other sectors of the economy. A shift toward services as the recovery continues will diminish the significance of this factor. Thus, it appears that the improvement in the underlying trend in productivity growth may be relatively modest, the 1 to 1-1/2 percent per year range. While this is considerably better than the performance during much of the 1970s, it nonetheless remains far below the near 3 percent per year increases experienced during the 1960s. It also suggests more moderate long-term economic growth than some forecasters have assumed.

On balance, it appears that the growth in potential output during the remainder of the decade is less than 3 percent a year. Furthermore, despite the fact that the recovery is only one year old and started from a relatively depressed level of economic activity, it is also likely that the amount of slack that currently exists in the economy is fairly modest. This reflects the fact that capacity is growing very slowly, due to the elimination of a considerable amount of previous capacity in many industries and the relatively depressed level of capacity related investment in recent years. In addition, the employment-to-population ratio is now almost 60 percent, close to a record high, and far above the rates that prevailed during most of the post-war era, despite still high unemployment.

Thus, on balance, it is highly possible that the maximum growth rate the economy can experience for the remainder of the decade, assuming favorable economic policies and a return to full employment by the end of the period, is only slightly above 3 percent. This is considerably less than the 4 percent plus average that underlies the latest Administration budget.

The Impact of Budget Deficits

Furthermore, it is highly likely that current economic policies, principally the bleak outlook for the Federal deficit, will prevent the economy from reaching an even more conservative estimate of potential GNP before the end of the decade.

The Administration's estimate of a relatively flat deficit for the next several years, followed by some decline near the end of the decade, already represents a significant departure from the sharp declines in Federal deficits that have taken place during previous economic recoveries. However, the Administration's projection is extremely optimistic because: (a) real economic growth will probably average considerably less than the 4 percent per year assumed for the remainder of the decade; (b) it assumes a sharp decline in interest rates during the next several years, which is unlikely; (c) while the Administration's forecast of inflation is probably on the low side, the deficit in future years will be relatively unaffected by the rate of inflation because of indexing of personal taxes, which becomes effective next year; and (d) it includes nondefense budget cuts and net tax increases totaling $160 billion for the 1985-89 period, much of which may not be legislated. On a current services basis, and with more realistic economic assumptions, the Federal deficit will begin to rise again by 1986, ultimately reaching about $300 billion per year by the end of the decade—this is consistent with recent estimates made by the Congressional Budget Office. Furthermore, the increase in the deficits in the years ahead will be structural in nature, reflecting a growing imbalance (under current policies) between expenditures and receipts—this is in sharp contrast to the large deficits in 1983 and 1984, of which at least half were cyclical. Structural deficits in the years ahead will not only reach unprecedented levels, but, by definition, will occur even with continued economic recovery. In the absence of sustained expansion, the deficit under current policies would likely approach or even exceed $400 billion per year by the end of the decade. The increase in structural deficits will reflect the large increases in military expenditures resulting from the military buildup now underway; continued sharp increases in the cost of entitlement programs, especially health, Social Security, and other pension programs; extremely rapid growth in interest payments; and tax cuts that have already been legislated but will become effective in the years ahead, including indexing of personal taxes scheduled for next year.

My concern about future deficits is that, unless the pattern is changed significantly, they are bound to cause significant upward pressure on interest rates during the next several years. Federal deficits in 1983 and 1984 are essentially being financed in part by four special factors: (a) Reflecting an enormous rate of increase in cash flow and depressed capital spending, U.S. corporations have been net savers (see **Figure 5**), accounting for a depressed level of corporate borrowing during this period. (b) Because of relatively high interest rates in the United States and political and economic instability in other parts of the world, foreigners have been highly willing to hold dollar-denominated assets in large quantities. Thus, the large outflow of dollars caused by record current account deficits have been invested in U.S. Treasury securities, U.S. common stocks, etc. (c) State and local governments have built up a large surplus during the last year, principally in pension funds. This results from the sharp increase in revenues caused both by the economic recovery and by large tax increases recently enacted, as well as the expenditure restraint by these governments during recent years. These surplus funds have been invested in capital markets. (d) Despite the finger pointing aimed at the Fed, Federal Reserve policies actually have been rather loose since the middle of 1982—in fact, since that time, M1 growth has averaged nearly 10 percent at an annual rate. Furthermore, over the last twelve months, the monetary base has risen by 9 percent. Virtually all measures of the availability of money indicate more rapid growth during the first year of this economic recovery than during the first year of most previous recoveries in the post-war period.

However, conditions are likely to change in the near future, leading to an increase in private credit demands on top of still rising Treasury borrowing, while the Federal Reserve begins to slow the growth in the money supply. Private credit demands, especially from the corporate sector, always rise sharply during the second and third years of economic recoveries. Corporate borrowing is already beginning to rise, since the fastest portion of the growth in cash flow is now over (profits are likely to grow far more slowly during the next several years (see **Figure 6**) because of slower growth in output and productivity) and captial spending and inventory investment are accelerating. Furthermore, spending by state and local governments is likely to gain momentum, especially for highway repair, maintenance, and construction, as well as other public works projects, reducing the current surplus position (see **Figure 7**). In addition, I believe that the Federal Reserve will make stronger efforts later this year and in 1985 to slow the growth in the money supply in comparison with the rates of increase recently experienced. This combination of forces will likely exert significant upward pressure on interest rates, especially since, in my view, the impact of future deficits is not being fully discounted in current rate levels. Real interest rates are higher than they have been historically, but the primary reason is deregulation of financial markets, rather than anticipation of future deficits. It is also important to note that even a faster than currently expected recovery in 1984 would not fundamentally change the interest rate outlook because, while this will reduce the cyclical component of the deficit more rapidly, it will be offset by faster growth in borrowing by the private sector resulting from the speedier recovery process.

One school of thought is that the economy can continue to expand, even with significantly higher interest rates, because the added fiscal stimulus from rising structural deficits would offset the adverse effect of rising interest rates—only a shift in the composition of output would occur. However, even if this scenario is correct, it would likely reduce long-term growth below current expectations because the shift in output mix would be toward more consumption and less investment—slower growth in investment would reduce long-term growth by reducing industrial capacity to support such growth, as well as by limiting the increases in productivity that result from new investment. Furthermore, the large and growing interest payments to foreigners would further reduce long-term growth by sapping resources away from the United States.

While such a reduction in potential long-term growth from an already modest rate would almost certainly thus occur as a result of growing structural deficits, I believe that the risks are even much more severe; in my view, the increase in interest rates that will eventually occur as a result of Federal deficits will very likely cause a new recession sometime during the next several years. While the economy is now less sensitive to a small change in interest rates than it was before financial market deregulation, the evidence of recent years clearly indicates that a large change in interest rates will have significant effects on the economy. This was witnessed during 1981, when the sharp increase in long-term rates became the major factor producing the deep recession during the second half of 1981 and 1982, and in 1983, when a sizable part of the recovery process was a direct result of the decline in rates in late 1982. The likely impact of higher interest rates in the next several years would include: (a) significant declines in interest rate sensitive sectors, such as autos, housing, and capital goods; (b) more upward pressure on the U.S. dollar, further eroding our competitive position in world markets, (c) delays in various infrastructure-related projects, as many municipal governments are priced out of the bond market; and (d) falling consumer confidence and household wealth, which, based on past experience, would likely cause significant cutbacks in household spending. In my judgment, there is a high likelihood that these downward pressures on the economy resulting from rising interest rates would more than offset the direct effect of the fiscal stimulus embodied in budget deficits, producing either a dramatic slowing of the recovery process or an outright recession.

Large and rising Federal deficits will also have other potentially adverse effects on the economy during the years ahead. (1) Because of the very rapid growth in interest payments, Federal expenditures and deficits have become far more sensitive to interest rates than has been true in the past. This has created an inflationary bias—pressures on the Federal Reserve to avoid higher interest rates in order to prevent even bigger budget deficits would require faster and faster growth in the money supply and higher, long-term inflation. (2) The U.S. is in danger of becoming hostage to developments overseas. In particular, U.S. policies in the future may have to be geared to prevent efforts by foreigners to reduce their holdings of dollar-nominated assets, such as preventing a decline in the exchange rate of the dollar and encouraging higher and higher interest rates. These policies would, of course, conflict with other goals, including the need for lower interest rates in order to hold down interest on the national debt, and the need for a correction in the value of the dollar in order to erase the competitive disadvantage of U.S. companies in world markets. (3) The longer it takes to reduce future deficits, the greater the risks become, and the harder they will be to reduce because of continued increases in interest expense and the likelihood of an economic decline that will make the deficit outlook even worse.

In sum, the Administration's long-term forecast appears optimistic even under the best of circumstances, so that the Federal deficit outlook is considerably worse than the most recent budget projects. Furthermore, the mere existence of these large deficits will even further worsen long-term economic growth and may, in fact, produce another recession during the next several years.

INFLATION OUTLOOK

The outlook for inflation in the very near term remains relatively favorable, with only a modest acceleration expected. This pickup in inflation will be heavily concentrated in food prices, reflecting the likelihood of sharp increases in the prices of meats, fruits, and vegetables—this has already begun to show up in recent data. Meat prices are likely to rise in response to a sharp decline in supplies because of cutbacks in herds following the rise in grain prices last summer. Grain prices increased at that time because of a sharp declines in production resulting from the drought and the impact of the PIK program. In addition, the extremely cold and snowy weather in December will aggravate meat shortages because many animals died during that period and others have not grown to normal weight. The same freeze, of course, has significantly reduced output of citrus fruits and vegetables, accounting for the increase in prices in these items. However, even with higher meat and citrus fruit prices, the overall inflation rate during 1984 will be modest, with little risk of a major acceleration until late in the year. This reflects: (a) Despite the recovery, the U.S. economy remains extremely competitive, preventing most industries from raising prices significantly. This reflects still high excess capacity, especially in those industries that compete on a worldwide basis; the impact of deregulation in many industries; and the effects of the highly overvalued dollar on companies that compete with foreign produced goods, and their suppliers. (b) The probability of an increase in oil prices in the immediate future remains extremely low. This primarily reflects the fact that worldwide demand for oil is still very weak—demand has actually fallen in Europe, where the winter has been relatively mild and where oil prices have actually risen during the past year. Furthermore, the recent warm weather in the United States has reduced pressures on heating oil; in fact, the winter thus far, while considerably colder than last year, is just about normal. Thus, in the absence of any supply interruptions, prices are unlikely to rise above current levels. (c) While food prices will rise more sharply this year than in recent years, reflecting the factors cited above, the likelihood of large increases in grain production will limit the increase in food prices to about 6 percent this year, causing only modest upward pressure on the inflation indexes.

In my view, the long-term outlook for inflation is less favorable; inflation will average approximately 6 percent for the remainder of the decade, with a significant risk of even higher inflation during this period. This reflects the following: (a) A significant downward adjustment in the value of the U.S. dollar on foreign exchange markets will eventually occur, contributing to higher inflation in the United States by increasing the cost of imports; by reducing the downward pressure on prices of competing domestic goods; and by causing some acceleration in dollar-denominated commodity prices. (b) While I believe the outlook for productivity is more favorable than it was during the 1970s, the strong pickup in productivity during the last year exaggerates the likely underlying trend in productivity growth. I believe that the underlying trend growth in productivity will probably be in the range of 1 to 1-1/2 percent per year, not sufficient to prevent some acceleration in inflation. (c) Wage increases are currently still very modest because of deregulation in transportation and other industries; because of still relatively high unemployment; because of modest cost of living adjustments in union contracts; because of continued efforts to control costs in response to foreign competitive pressures; and because of a relatively light bargaining schedule. However, it is very likely that wage increases will accelerate somewhat during the next several years in response to the recent surge in corporate profits. (d) Continued increases in energy demand will likely begin to exert some modest upward pressure on oil prices later in the decade, unlike the recent pattern. (e) Continued economic recovery will begin to cause some capacity constraints and labor shortages during the next year—this problem will be aggravated in some selected industries by the large military buildup. (f) Even with the sharp rebound in profits in 1983, profit margins are still well below historical levels. As a result, many companies will take advantage of every opportunity to raise prices in the years ahead in order to rebuild margins further.

These factors will combine to produce an average rate of inflation of about 6 percent during the remainder of the decade—more evidence of an acceleration in areas other than food should begin to become apparent toward the end of 1984. Furthermore, if the Federal Reserve were to attempt to avoid higher interest rates that could result from Federal deficits by expanding money growth more rapidly, the inflation outlook for the years ahead would be considerably worse. My forecast for inflation for the next several years is shown in Table 2.

ANTI-INFLATION POLICIES

In my judgment, the most important policy action necessary to avoid a major resurgence in inflation in the years ahead is to significantly reduce future Federal deficits. In particular, I would advocate any combination of spending cuts and tax increases, which, with reasonable economic assumptions, would produce a downward trend of $30 to $40 billion per year, beginning with fiscal 1985, in the Federal deficit. Such a pattern would reduce the likely Federal deficit by the end of the decade to $100 billion per year, or even less.

In addition, I advocate consideration of the following micro policies.

1. **Oil prices and supplies.** It is essential that another period of massive increases in energy prices be avoided. Thus, any programs or tax changes to encourage the development of alternative fuels, encourage new exploration, or provide government stockpiles to prevent shortages should be considered—this may include tax increases on various types of energy.

2. **Capital spending and productivity.** New policies to stimulate more investment, which would stimulate productivity growth, accelerate economic growth, and lower inflation, should also be considered. Macro policy changes that produce lower interest rates while keeping inflation down are important in this respect. In addition, tax credits for research and development are long overdue. Furthermore, despite the Administration's movement in the opposite direction, national standards for education in the areas of mathematics and science should be strongly considered, and programs designed to increase instructor skills in these areas should be implemented as early as possible. Finally, it is important to free up as much capital as possible from other areas to finance more capital spending—this can be accomplished by reducing the interest deduction on merger activity, as well as by gradually reducing subsidies to nonexport industries.

3. **Wages.** Although the overvalued dollar is a major factor behind the competitive disadvantage that many U.S. companies are encountering in world markets, extremely high wages in many manufacturing industries relative to those overseas compound the problem. Several changes should be considered to prevent a repeat of the rapid growth in wages that took place in many of these industries during the 1970s: (a) The three-year bargaining cycle that characterizes many manufacturing industries is clearly too long—one-year bargaining should be instituted. This, in turn, would eliminate the need for COLAs. (b) No subsidies or protection should be provided for any domestic industry unless costs are reduced, especially wage costs; otherwise, these protectionist measures can be counterproductive, since they reduce the need for cost-reducing actions in these industries.

4. **Manufacturing Exports.** The importance of manufacturing exports to any industry is now becoming increasingly apparent. In addition to contributing to higher production and employment levels, higher levels of exports in a given industry help reduce unit costs because of the economies of scale that result. The following incentives for exports should be considered: more low-cost loans similar to those offered by other countries; more funding for the Ex-Im Bank; increased assistance to U.S. companies in need of more information about selling in foreign markets; more liberalized export trading company rules; and a change in antitrust laws that will enable U.S. companies to collaborate on product development and in the development of new technology for overseas markets.

FORECAST SUMMARY

Table 3 summarizes my current forecast for key economic indicators for the next several years. Underlying the forecast are the following major assumptions:

Taxes

$6.5 billion increase in 1985
  $2 billion personal
  $3 billion corporate
  $1.5 billion excise

Additional $28 billion increase in 1986
  $15 billion personal tax rate increase
  $5 billion loophole closing
  $5 billion corporate
  $3 billion excise taxes

Government Spending

Slightly above budget targets

Money Supply

Upper range of 4% to 8% target for M1

Interest Rates

Flat in near term
Rising trend 84.4 to 85.3
Modest declines thereafter

Oil Prices

No increase until 1986

International

Modest recovery overseas
Modest weakening in dollar

Figure 1

M1 GROWTH - 4TH Q. OVER 4TH Q.

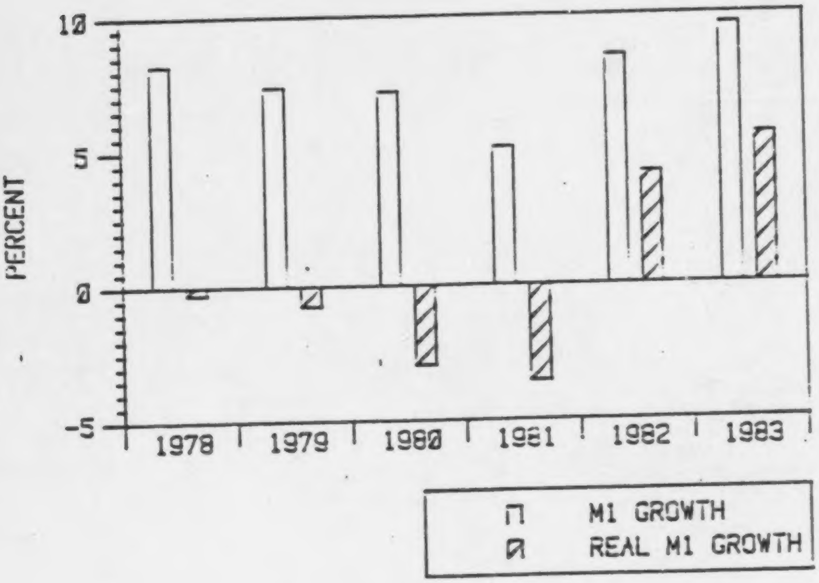


Figure 2

MONETARY BASE

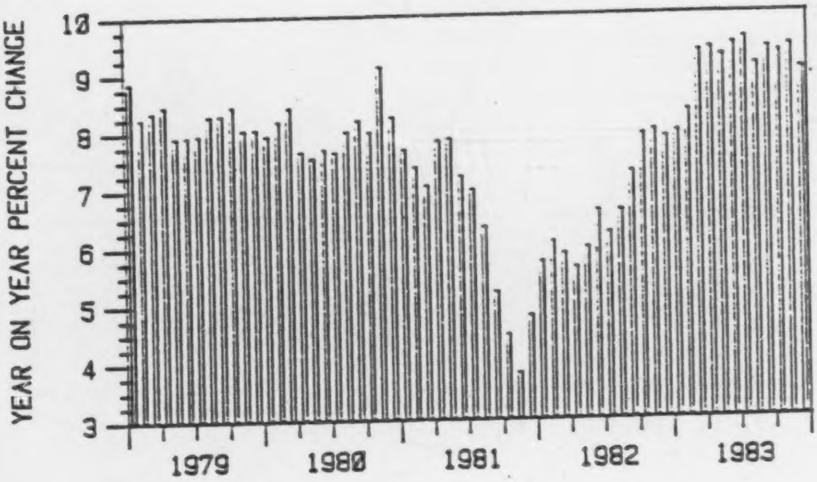


Figure 3

LABOR FORCE GROWTH

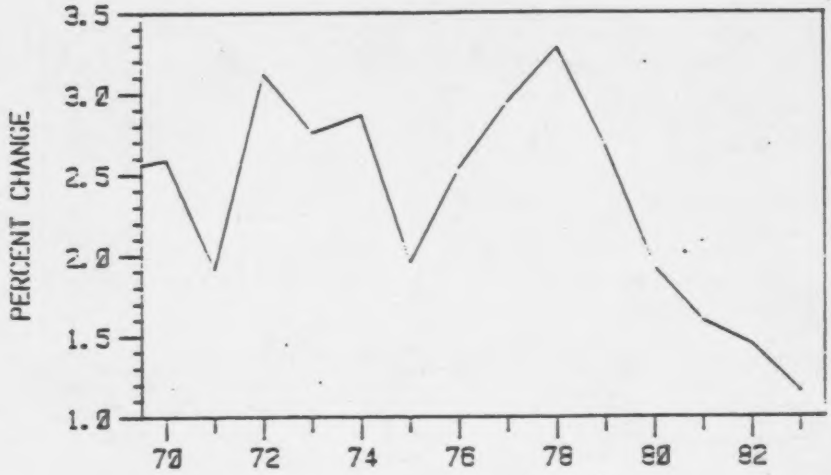


Figure 4

NONFARM PRODUCTIVITY GROWTH

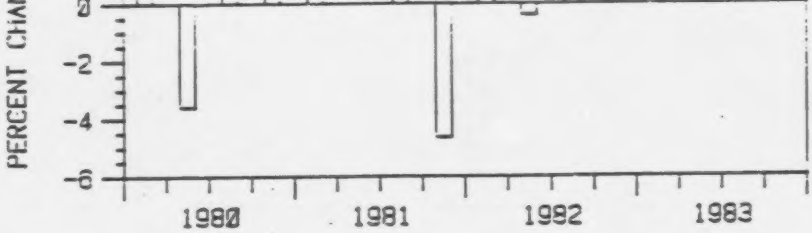


TABLE 1
INCREASE IN PRODUCTIVITY
FOUR QUARTERS FROM TROUGH

	PERCENT CHANGE
1954.2 - 1955.2	5.0
1958.2 - 1959.2	4.9
1961.1 - 1962.1	5.5
1970.4 - 1971.4	3.7
1975.1 - 1976.1	5.1
1982.4 - 1983.4	3.5

Figure 5

CORPORATE CASH FLOW AND INVESTMENT

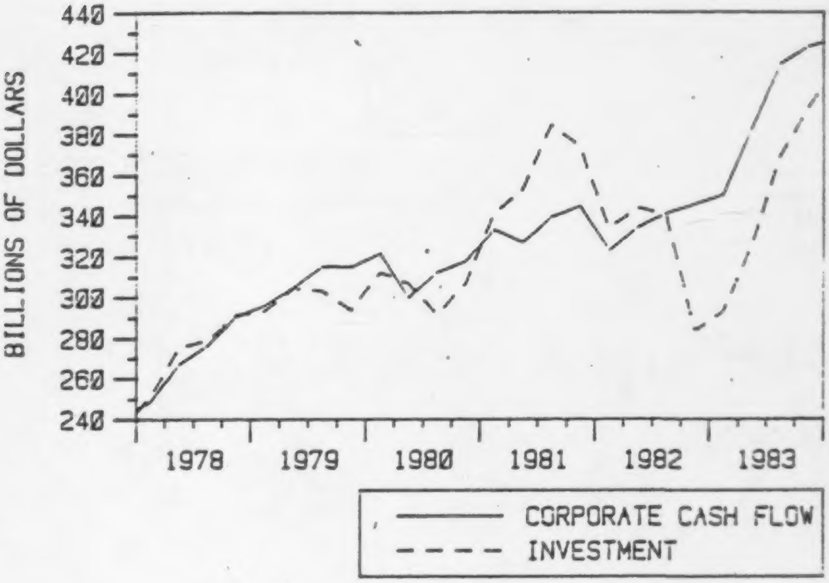


Figure 6

PROFITS, WITH IVA AND CCADJ

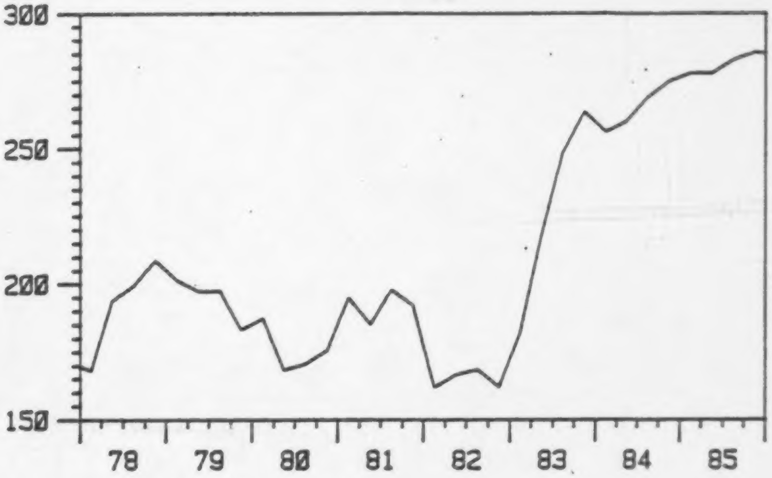


Figure 7

STATE AND LOCAL GOVERNMENT SURPLUS

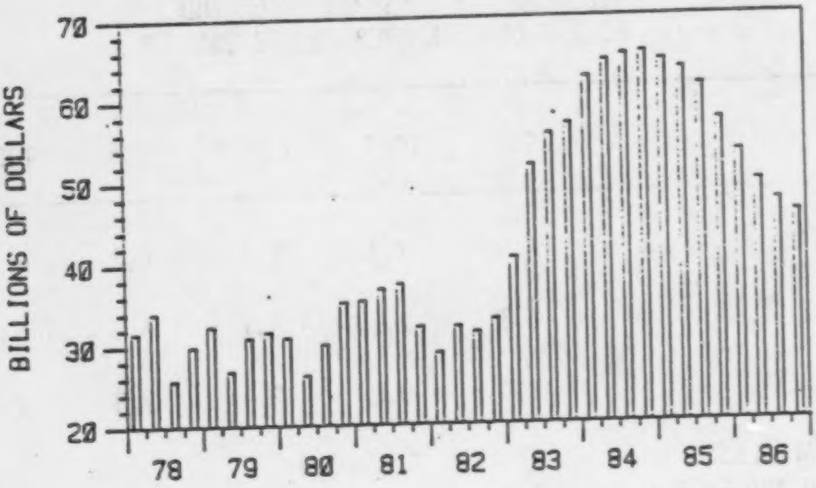


TABLE 2

INCREASE IN CONSUMER PRICE INDEX FOURTH QUARTER OVER FOURTH QUARTER

	1982	1983	1984	1985	1986
TOTAL	4.5	3.3	5.3	5.7	5.3
FOOD	3.3	2.2	6.1	5.9	5.0
ENERGY	1.9	-0.6	2.4	2.8	7.7
TOTAL, LESS FOOD AND ENERGY	5.2	4.3	5.4	6.1	5.4
MEDICAL CARE	11.0	6.7	7.0	7.5	7.8
SHELTER	3.8	3.3	5.0	5.9	5.1

TABLE 3
FORECAST SUMMARY TABLE
(% CHANGE)

	1981	1982	1983	1984	1985	1986
REAL GNP	2.6	-1.9	3.3	5.4	2.7	3.1
INDUS. PRODUCTION	2.6	-8.1	6.5	9.8	3.3	3.3
REAL CONSUMPTION	2.7	1.4	4.2	4.8	3.1	2.9
REAL FIXED INVEST.	5.2	-4.7	1.5	13.1	5.3	3.5
CPI	10.3	6.2	3.2	4.9	5.6	6.3
GNP DEFLATOR	9.4	6.0	4.2	4.2	5.8	6.3
PRE-TAX PROFITS	-3.3	-23.2	18.6	12.4	7.0	12.2
UNEMPLOYMENT RATE(%)	7.5	9.6	9.4	7.5	7.6	7.7
PRIME RATE (%)	18.9	14.9	10.8	11.1	12.8	11.4
AUTO SALES (MIL.)	8.5	8.0	9.2	10.4	10.5	10.9
HOUSING STARTS (MILLIONS)	1.10	1.06	1.70	1.85	1.52	1.76

Representative MITCHELL. Thank you very much. If you observed me at all, you saw I was scribbling notes because you made so many interesting and salient points. If it is all right with you, I would like to hear from Mr. Moore next, and then we can put questions to both of you.

I am delighted that Congressman Hawkins from California has joined us.

Mr. Moore, thank you for being here.

STATEMENT OF GEOFFREY H. MOORE, DIRECTOR, CENTER FOR INTERNATIONAL BUSINESS CYCLE RESEARCH, COLUMBIA UNIVERSITY, NEW YORK, N.Y.

Mr. MOORE. Thank you very much, Congressman. I am delighted to be here.

I have, as you know, a prepared statement for the record.

Representative MITCHELL. Without objection your prepared statement will be inserted into the record.

Mr. MOORE. Let me summarize it briefly.

The first point that I make is that the administration's forecast, as indicated in the President's economic report, for the next 2 years, that is, 1984 and 1985, is very much in line with the average record of previous expansions, going back to 1948.

The first three charts in my prepared statement, which relate to real GNP, employment, and unemployment, demonstrate that point. The expansion patterns that are plotted on those charts, that is, the averages for the six previous expansions, are the heavy solid line on the charts. The light solid line is the current expansion which began in the fall of 1982 and has continued to date. The two points that are marked with circles are the administration's forecasts for 1984 and 1985.

They, as you can see, are very much in line with both the recovery that has gone on so far and the average of previous recoveries that we have experienced in this country for those three broad measures of activity.

Now, it seems to me that this position is a reasonable one to take, so long as there is no evidence that the economy is getting out of line with the previous record of business cycle expansions.

One way of looking at that record and getting an early warning if things are getting out of line is to look at the leading indicators, which are plotted on charts 4 through 9. They relate to business activity in general in the Business Week leading index which we construct at the Columbia Center, or business activity as measured by the leading index published by the Commerce Department, labeled BCD in charts 6 and 7, or the leading employment index that we construct at the Columbia Center, which focuses strictly on employment activity.

In all three of those leading indicators and their growth rates, the current recovery to date is pretty much in line with the past average. The most weakness shows up in the Business Week leading index. But even that has begun to show some recovery in the last month or so from the levels that it got to in December and January.

So in general, summing up the evidence from the leading indicators, I think there is support for the idea that the recovery will continue at about an average pace based on past experience, which is what the administration forecast assumed.

Now, with respect to inflation, the situation I think is somewhat different. Chart 10 in my prepared statement, which is essentially the one reproduced on a large scale on your chart over there, shows the growth rate in the Consumer Price Index in the current recovery as compared with its average in previous expansion periods. The administration forecasts, which are at a level of 4.4 percent for 1984 and 4.6 percent for 1985, seem to me to be on the low side.

The January rate of increase, as calculated by our method of calculating the inflation rate, was 6.4 percent. It is already up to the levels that the administration had forecast for the next 2 years.

And the leading index of inflation which we construct, which is shown in chart 11, suggests that the excess over the previous average experience is likely to continue and possible even grow larger.

The relationship between that leading index and the Consumer Price Index is, and has been in the past, that it generally begins to pick up several months before—possibly as many as 6 months before—the inflation rate begins to pick up. In the current situation that is exactly what happened. It began rising after December 1982, whereas the inflation rate in the Consumer Price Index did not begin to rise until after March 1983.

The leading index of inflation has continued to rise more rapidly than its average past record. That is true through January of this year.

So I suspect, on the basis of past relationships, that the inflation rate in the Consumer Price Index will continue to rise and possibly hit something like a 7 percent or possibly 8 percent annual rate during 1984.

The three components of the leading inflation index are shown in charts 12, 13, and 14.

One of them measures the tightness of the labor market in terms of the percentage of the population of working age that is employed. And as you can see from chart 12, that percentage has been rising rapidly during this recovery and is at a relatively high level compared with previous experience.

So that indicates a tightness in the labor market that I think is likely to put both upward pressure on wages and provide more money for people to spend and more confidence and willingness to spend it because of their employment situation.

The second component in the leading inflation index is the rate of growth of industrial materials pieces. We use those as a sensitive indicator of what's going on in commodity markets that in the past have been very sensitive to supply and demand pressures and inflationary movements. Usually those prices are among the first to go up when inflation begins to accelerate, and the first to come down when the opposite trend occurs.

Well, those prices accelerated very rapidly early last year. And the rate of increase that we still record for that measure of price acceleration is still at the 18 percent annual rate level, which is not particularly different from the average experience in the past expansion periods but still is a relatively high rate.

That increases costs of production for the manufacturers buying materials, and it is also a measure of their demand for those materials for inventories and other purposes of production.

The third component of our leading inflation index is the growth rate in business, consumer, and Federal debt, as shown on chart 14. That, too, has shown a rise in its growth rate that exceeds its average pattern of past periods of expansion through December.

That series is included in the leading inflation index because it is a measure of purchasing power that is added through its growth to the economy through bank credit and other types of credit expansion. When that debt expands, it not only gives people more ability to spend and to increase the volume of spending but also gives them the ability and willingness to pay higher prices. Frequently it leads to both higher prices and more spending as a whole.

Now, let us look at a little more detail on the Federal debt and the business and consumer debt growth rates as shown in charts 15 and 16 in my prepared statement.

The growth rate of Federal debt obviously reflects the deficits that we have been experiencing. Although there has been some diminution in that growth rate in the last 6 months, it is still at a very high level relative to past experience, in the neighborhood of 17 or 18 percent at an annual rate. The two projections that are shown in chart 15, from the administration's deficit forecast, are at about the same level as the current rate, both for 1984 and for 1985, in the neighborhood of 16 to 18 percent at annual rate.

Again, those rates are exceptionally high relative to previous experience that we have had with the growth rate in the Federal debt.

On the business and consumer debt side, the growth rate also has been rising but is still relatively low compared with the average of previous experience through December. The growth rate in December was in the neighborhood of 7 or 8 percent, quite a bit below the average of previous experience in the growth of that type of debt.

I think these debt figures are fundamental to the longer run inflation outlook as well as to the immediate future. In the table attached to my prepared statement entitled "Links Between Debt, Real Growth, and Inflation," I tried to lay out some of the history of the various factors that have influenced the inflation rate, and the level of interest rates, over relatively long periods. These periods, as shown in the table, cover the whole of a business cycle running from the peak of an initial cycle to the next peak. So the up-and-down swings during the cycle are not shown there at all. These are in effect trend rates of growth measured from the peak of one business cycle to the peak of the next cycle.

That way you get, I think, a much clearer idea of what the longer run relationships are between the money supply on the one hand and the growth in debt on the other, to the rate of inflation. By glancing over those numbers from the left to right in the table, you can see as inflation grew during the 1970's and early 1980's, so also did the growth rate in the money supply and the growth rate in debt.

In particular, what you can see from the growth rates in debt is that the growth rate in the Federal debt was very largely responsible for the acceleration in the growth of total debt that occurred during the 1970's. The growth rate in total debt got up to 11 percent in the cycle from 1973 to 1980. It dropped a bit, to 9 percent, in 1980 to 1981. Those rates of growth in total debt were very largely the result of the acceleration of the Federal debt to 11 and 12 percent annual rate.

As I pointed out earlier, the current rate of growth in Federal debt exceeds those numbers, and the growth rate in total debt is getting up very close to those levels. It is now at about an 8-percent annual rate.

The projections for the deficits that are in the administration's budget, and also in the Congressional Budget Office analysis, can be translated into growth rates in Federal debt also, going out to the end of the decade. What we see is that the administration's projections show a declining growth rate from about 17 percent annual rate for 1984 down to 15 in 1985, and down further to 12, 11, 8, and 6 by the end of the decade. These are annual percentage growth rates of Federal debt.

The Congressional Budget Office's deficit projections also decline but not nearly as much. They start from a 17 percent annual rate for this year and end up at about an 11 percent annual rate in 1989, rather than the 6 percent that is projected by the administration.

The overall average over the 6 years, from 1983 to 1989, turns out to be a 12-percent annual rate of growth in Federal debt as projected by the administration, and a 14-percent annual rate of growth as projected by the Congressional Budget Office.

Both of those percentages are very high relative to the long-run record that I described earlier. And since in the past the acceleration of the Federal component of total debt has been the accelerating factor in the growth of total debt, it seems to me this is a very ominous picture for the next half-dozen years.

What it means, it seems to me, from the policy point of view, is either that that growth rate in Federal debt will be accommodated in the 12 to 14 percent annual rate range, and private debt will accelerate as well, in which case we are virtually certain to get a very considerable acceleration of inflation, or if the growth in Federal debt is accommodated and the Federal Reserve clamps down on the private sector, then the growth rate in the economy will not turn out to be as favorable as is projected.

Hence, the maintenance of such high growth rates in Federal debt is likely to bring about either inflation, if they are accommodated in the total economy, or a much slower growth rate in the economy if they are not accommodated.

The solution seems to me to be a control on the growth rate of Federal debt. I make a modest proposal that might be considered by this committee, that in thinking about the budget and projecting it for a year or two ahead, it might be desirable for the Congress to set a percentage rate of growth in the Federal debt that would operate as a ceiling. That has the advantage of representing a relatively simple number—a percentage growth rate—that can be readily understood by the public, as to whether it is large or small.

Everyone can recognize that a 15 percent annual rate of growth in total Federal debt is a high number, whereas 5 percent is far more modest. And it can be readily related, as I have tried to indicate in my prepared statement, to the rate of inflation.

So setting such a limit on the growth rate in Federal debt would have, I think, a public relations advantage with respect to control over the Federal budget and make the relationship between the growth of debt and the growth of the economy and inflation easier for the public to understand.

With that, Congressman, I conclude my testimony.

[The prepared statement of Mr. Moore, together with an attachment, follows:]

PREPARED STATEMENT OF GEOFFREY H. MOORE

The administration's forecasts for 1984 and 1985 are closely in line with the average pattern of previous expansions, as compiled by the Center for International Business Cycle Research at Columbia University. The heavy line in Chart 1 shows how real GNP advanced on average during the first 2½ years of the six expansions from 1948 to 1980. The lighter line traces the movement in real GNP during the current expansion to date, starting in November 1982. The x's identify the projected figures for 1948 and for 1985, as given by the Council of Economic advisors in the Economic Report of the President.

The projections for employment (Chart 2) and unemployment (Chart 3) also resemble the previous expansion patterns, with employment continuing to rise and unemployment declining. In general, the present expansion to date has adhered closely to the historical average, and the Council's projections are telling us to expect more of the same in 1984 and 1985.

It seems to me that this is a reasonable position to take, unless or until there is evidence that matters are getting out of line. The historical averages have certainly offered a good guide during the past year. This has been true not only for GNP, employment and unemployment, but also for the leading indexes compiled by the Commerce Department and by the Columbia Center (CIBCR), as shown in Charts 4 through 9.

At about this time last year, the leading indexes and their corresponding growth rates were showing the rapid growth that is characteristic of the early stages of a recovery. More recently they have been exhibiting the slowing down that is characteristic of the later stages. The slowdown started sooner and has proceeded somewhat farther in the Business Week leading index than in the Commerce Department's index or in the Center's leading employment index. Nevertheless, taken as a whole the evidence suggests that 1984 will see a continuation of the economic expansion at something close to the average pace.

With respect to inflation, the situation is rather different. The rate of inflation in consumer prices, shown in Chart 10, has usually reached its low point during the early months of a recovery period, and then has moved up as demand increases and cost pressures mount. In the present recovery the CPI rate hit its low, 1.8%, in March 1983, four months after the recovery began. Since then the rate has risen much faster than in the average recovery, to 4.6% in January 1984. This is already up to the average rates projected by the Council for 1984 and 1985, 4.4% and 4.6%, respectively.

The faster-than-usual acceleration in inflation was indicated well in advance by the Columbia Center's leading index of inflation (Chart 11). This index reached its low in December 1982, three months before the low in the inflation rate. It has moved up at a faster than average pace since then, anticipating the acceleration in the inflation rate. Judging from its past relationship to inflation, the index suggests that inflation may reach seven or eight percent sometime this year.

The three components of the index, which are shown in Charts 12, 13 and 14, were selected to represent the influence upon inflation from three principal sources. Labor market pressures are represented by the percentage of the working age population that is employed (Chart 12). The economic recovery has pushed this percentage up more rapidly than usual, and to much higher levels. This spells both tightness in labor markets and an improved capacity to spend. The second component measures pressures in the commodity markets, as reflected in the prices for industrial materials such as copper and textiles. These prices advanced rapidly last spring, and the advance has continued, although at a slower pace in recent months (Chart 13).

The third component of the index represents pressures in financial markets arising from the growth of business, consumer and Federal debt (Chart 14). Rapid growth in total debt not only finances a larger volume of business but also supports the higher prices. During the current recovery the growth in debt has exceeded its average rate during previous recoveries. Hence all three of the components of the leading index of inflation have been pushing the index up, and supplying reasons for expecting the inflation rate itself to climb. My conclusion is that the inflation rate is likely to turn out to be higher in 1984 than the Council's projections.

This conclusion is based in part on the trend in the Federal deficit. The anticipated $200 billion deficit for fiscal 1984 translates into an annual growth rate of about 17% in Federal debt. Similarly, the expected deficit of $195 billion for fiscal 1985 will be increasing the Federal debt at an annual rate of about 15%. As shown in Chart 15, these are unprecedented rates of growth for an economic recovery period. The growth of business and consumer debt, on the other hand, is well below its average path, although the shortfall has been diminishing (Chart 16). If business and consumer debt continues to accelerate, while Federal debt continues to grow at its present pace, the growth of total debt will far exceed its historic average, placing great pressure on the inflation rate.

The consequences of failing to get the Federal deficit under control can be readily seen if one looks at periods that span an entire business cycle. The evidence is presented in the attached article published in the February 1984 issue of Across the Board. The salient findings are: (1) that growth in total debt has been closely related to the rising rate of inflation in recent cycles, and (2) that the faster growth in total debt in recent times has clearly been the result of the faster growth in Federal debt. In the last two cycles the growth rate of the Federal debt averaged 11 and 12 percent, respectively. The Administration's projected deficits to 1989 translate to an average annual growth rate in Federal debt of 12 percent, about the same as in the last two business cycles. In those two cycles, however, the inflation rate averaged 9 and 11 percent per year, respectively. If we are to avoid repeating that inflation experience, either the growth of Federal debt must be restricted, or a corresponding restriction must be placed on the growth of private debt. The latter restriction, however, is likely to mean a slower growth of total output than the Administration has projected to 1989. If we are to attain the twin goals of rapid growth without inflation. the essential ingredient is modest growth in Federal debt.

To achieve this I suggest that the Congress consider legislation that would require establishing each year a maximum growth rate for the Federal debt, expressed as a simple percentage. The ceiling on the rate might well vary from year to year, depending on economic conditions. In general, the ceiling should be higher under recession conditions and lower when, as now, an expansion is underway. By exercising direct control over the growth rate in Federal debt, the Congress would demonstrate its awareness of the inflationary consequences that the double-digit growth rates in the Federal debt since the 1970's have had.

PATTERNS OF CURRENT AND PREVIOUS EXPANSIONS

CHART 1. REAL GNP

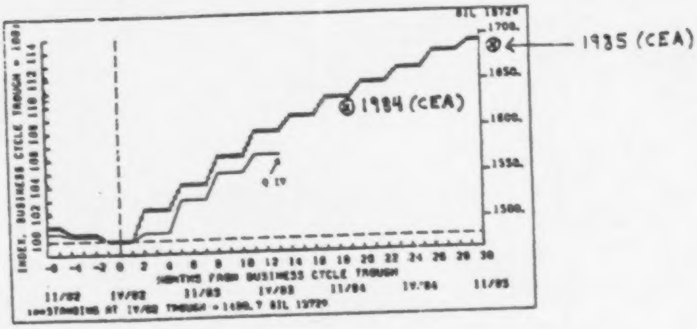


CHART 2. TOTAL EMPLOYMENT

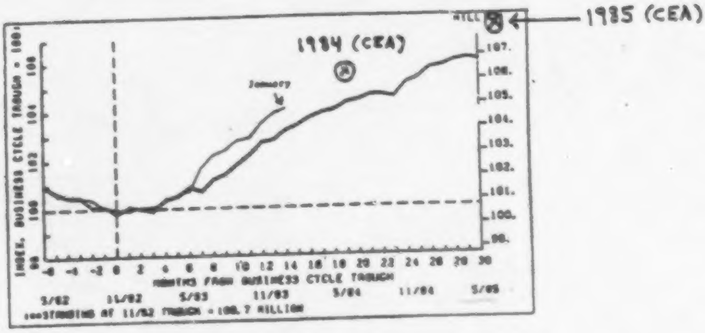


CHART 3. UNEMPLOYMENT RATE

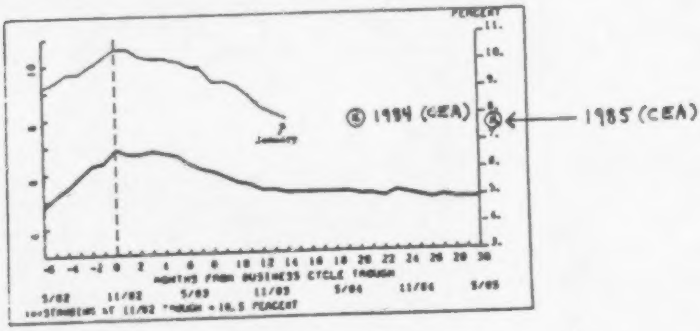


CHART 4. BUSINESS WEEK LEADING INDEX (CIBCR)

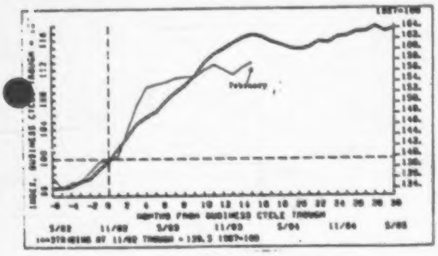


CHART 5. BUSINESS WEEK LEADING INDEX, GROWTH RATE

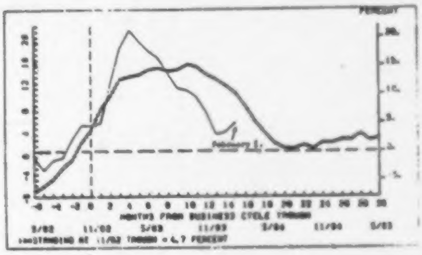


CHART 6. LEADING INDEX (BCD)

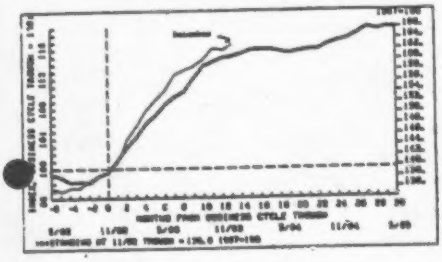


CHART 7. LEADING INDEX, GROWTH RATE (BCD)

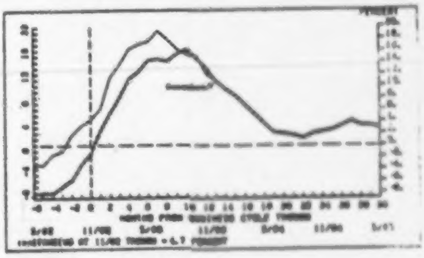


CHART 8. LEADING EMPLOYMENT INDEX (CIBCR)

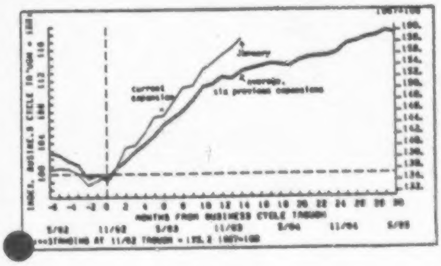


CHART 9. LEADING EMPLOYMENT INDEX, GROWTH RATE (CIBCR)

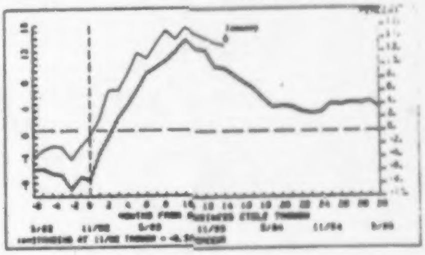


CHART 10. CONSUMER PRICE INDEX, GROWTH RATE

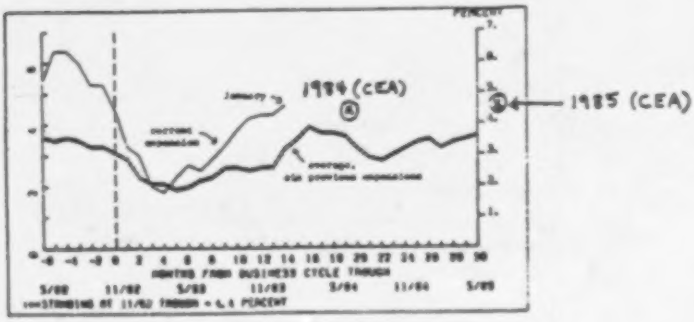


CHART 11. LEADING INDEX OF INFLATION (CIBCR)

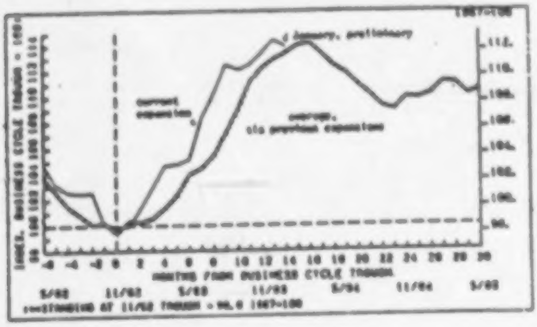


CHART 12. PERCENTAGE OF POPULATION EMPLOYED

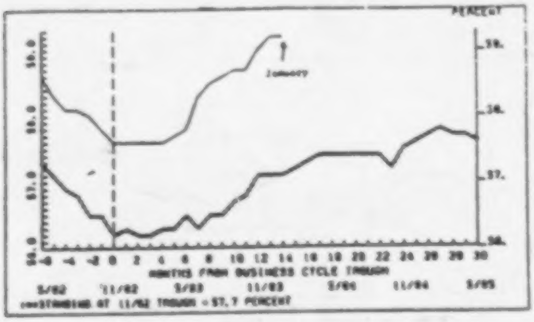


CHART 13. INDUSTRIAL MATERIALS PRICE INDEX, GROWTH RATE

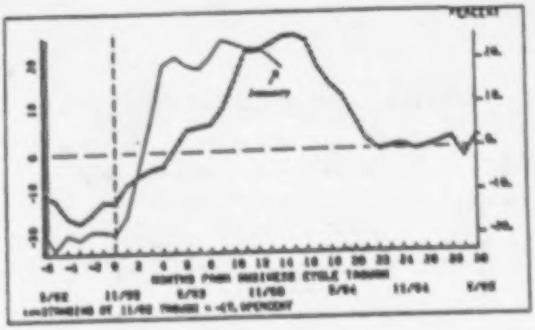


CHART 14. BUSINESS, CONSUMER & FEDERAL DEBT, GROWTH RATE

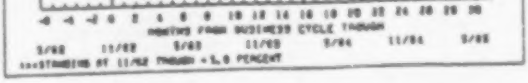


CHART 15. FEDERAL DEBT, GROWTH RATE

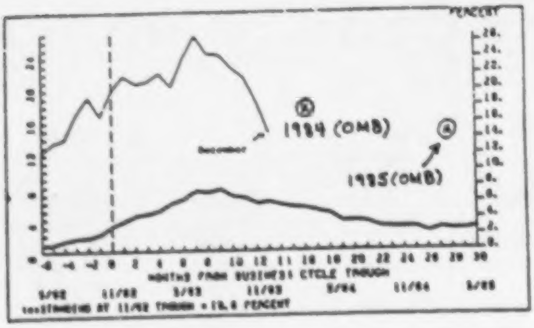
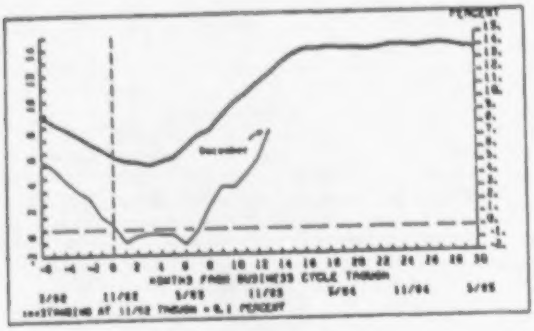


CHART 16. BUSINESS & CONSUMER DEBT, GROWTH RATE



The blind men and the deficit elephant

by Geoffrey H. Moore

One reason why the impact of Federal deficits is so controversial is that it varies considerably at different stages of the business cycle. Like the blind men describing different parts of the elephant, economists reach almost diametrically opposite conclusions depending on what part of the business cycle they are examining.

For example, during a business cycle upswing, which is what we have now, the deficit usually declines. But interest rates and the rate of inflation usually climb. Does this mean that a declining deficit is a bad thing, because it is associated with higher interest rates and more inflation?

Similarly, during a recession the deficit rises while interest rates and the rate of inflation drop, as they all did during 1981–'82. From this it might be easy to conclude that all we need to get interest rates and inflation down is a bigger deficit—and a recession. After all, the Reagan Administration presided over the biggest Federal deficit of all time, but achieved the biggest reduction in interest rates and inflation rates in many years.

To avoid mixing up causation and correlation, as the above statements do, it is helpful to put business cycles aside and look at what has happened from one cycle to the next. This will not avoid the problem altogether, since we can still observe only correlation and must infer causation. But it does show the long-run correlation is very different from that of the short run.

The figures in the table on the following page are arranged to do this. Each number is an average for a period starting from the peak of one business cycle and ending at the peak of the next. What happens in between the peaks—a recession and the subsequent expansion—is thus ironed out. We are looking across the valley, ignoring all the trauma down there. The table shows the rate of inflation, the prime rate, the rate of economic growth in nominal as well as real terms, the percentage employed, the unemployment rate, the growth in the money supply, and the growth in private and Federal debt—all the really important things! The deficit is measured by the growth in Federal debt, a superior measure in that it includes Government expenditures that are not in the unified Federal budget and expresses the figures in terms of a *percentage* growth rate, comparable with other indicators like the growth in money and GNP. All the figures in the table are percentages.

Here are some of the things the table tells us about the period from 1948 to 1981:

1. The rate of inflation and the level of interest rates have generally risen for more than three decades, though not always in close step.

2. While growth in GNP in current prices has speeded up, growth in real GNP has slowed down. That's inflation—or stagflation.

3. While the unemployment rate is much higher than it used to be, so is the percentage employed. Lest you think this is arithmetically impossible, note that the unemployment rate is a percentage of the labor force (employed plus unemployed) while the percent employed is based on the entire population of working age (16 and over). If unemployment were expressed as a percentage of the working-age population, the rate would be lower but the trend would still be up. Fewer Americans are neither working nor seeking work.

4. Money-supply growth, whether of the broad or narrow variety, has accelerated along with prices, interest rates, and the growth in nominal GNP. But rapid growth in money has not been associated with faster growth in real GNP.

5. The growth in private debt has been remarkably stable. Hence, it shows little connection with either prices or interest rates, real or nominal growth.

6. Federal debt has grown in every cycle except 1953–57, but at much faster rates in recent years. More rapid growth in Federal debt has gone together with more rapid increases in prices, higher interest rates, and faster growth in nominal GNP, but with slower growth in real GNP.

7. The bottom line is the growth in total debt, which has speeded up just like the money supply and hence bears a similar relationship

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Geoffrey H. Moore is director of the Center for International Business Cycle Research at Columbia University.

February 1984 Across the Board The Conference Board

Commentary

Links Between Debt, Real Growth, and Inflation

(Business-Cycle Averages, Peak to Peak)

	Nov 1948 –July '53	July 1953 –Aug. '57	Aug.1957 –Apr '60	Apr 1960 –Dec. '69	Dec 1969 –Nov. '73	Nov 1973 –Jan. '80	Jan.1980 –July '81	Average Nov. 1948 –July '81
Inflation rate (% per year)								
Consumer price index	2.2	1.3	1.2	2.6	5.2	9.0	10.9	4.2
Interest rates (%)								
Prime rate	2.5	3.4	4.3	5.3	6.7	9.1	16.7	[illegible]
Economic growth rate (% per year)								
Nominal GNP (at current prices)	7.1	5.1	4.4	7.0	9.4	10.5	10.0	[illegible]
Real GNP (in constant prices)	4.9	2.5	2.6	4.2	3.9	2.8	0.6	[illegible]
Jobs (%)								
Percentage of population employed	57.3	57.5	56.6	57.1	57.8	58.4	59.6	57.6
Unemployment rate	4.1	4.3	5.6	4.6	5.2	6.6	7.1	5.2
Money growth (% per year)								
Narrow money supply (M1)	3.1	1.4	1.8	4.0	6.6	6.6	6.3	[illegible]
Broad money supply (M2)	3.3	2.7	5.0	7.3	10.0	10.0	9.4	[illegible]
Growth in debt (% per year)								
Private nonfinancial	10.9	9.7	8.8	8.8	10.5	11.2	8.9	9.9
Federal	1.2	-0.5	2.2	2.1	4.9	11.3	11.8	[illegible]
Total	5.8	5.4	6.5	7.0	9.4	11.2	9.4	7.8

Source *Business Cycle, Inflation and Forecasting* by Geoffrey H. Moore, Ballinger Publishing Co., 2nd ed., 1983

to inflation, interest rates, and the growth in nominal GNP. Debt and money provide purchasing power, and when they grow rapidly, prices rise more rapidly, too.

8. The faster growth of total debt in recent times is clearly the result of the faster growth of Federal debt. That is one of the advantages of looking at the debt instead of the money supply—one can see directly what the Federal deficit is doing. It has not, in fact, crowded out private debt, at least in nominal terms. It has just made the total debt grow faster. And the spending power represented by the fast-growing debt was dissipated in a more rapidly rising price level. It did not produce more real growth.

9. The long-run relations between the Federal deficit and the economy, as traced in the table, are very different from those we described initially as features of the business cycle. If we are to stop the long-run inflationary trend, the long-run trend toward more rapid growth in debt must be broken also. Since the chief culprit has been the growth in Federal debt, that is the appropriate target.

Currently, the Federal debt is growing at double its average pace in the 1980–'81 business cycle. That is, in November 1983 the annualized growth rate in Federal debt was 19 percent. With private debt growing at only a 5 percent annual rate, the growth rate in total debt in November 1983 was 9 percent. Experience, as indicated in the table, has shown that a 9 percent pace, continued over the course of a business cycle, is too high to contain inflation. In the light of history, it is difficult to see how the problem will be resolved over the next few years without some sort of ceiling on the growth of Federal debt. Although ceilings on the level of Federal debt haven't worked too well—Congress is tempted to keep raising them—maybe ceilings on the debt *growth rate* would. The growth-rate ceiling could be expressed as a simple percentage, more graspable by the public, and perhaps even the Congress, than the elephantine figures in which the Federal debt is expressed. Ideally, the ceiling would be in the single-digit range. ■

Representative **Mitchell**. Thank you very much, Mr. Moore.

Mr. Chimerine and Mr. Moore, unless you have objection, I think we might go ahead with Mr. Kudlow, and then put questions to all three of the panelists.

Before you proceed, I would like to acknowledge that Congressman Bedell from Iowa is with us.

Please go ahead. I think we have copies of your prepared statement.

STATEMENT OF LAWRENCE A. KUDLOW, PRESIDENT, LAWRENCE KUDLOW & ASSOCIATES, INC., WASHINGTON, D.C.

Mr. **Kudlow**. I will be quite brief. The major points of my prepared statement are roughly as follows.

Representative **Mitchell**. First of all, let me indicate your prepared statement will be inserted into the record, without objection.

Mr. **Kudlow**. Thank you.

I believe that fiscal policy at this stage comprises the single largest threat to the outlook for inflation and the outlook for sustained economic growth and the outlook for interest rates as well.

In my judgment, fiscal policy is highly expansive at the present time. It is unduly so for this stage of the business cycle. And it is going to have significant effects with respect to monetary policy, Federal Reserve conduct of monetary policy, and the supply of high-powered money and money supply, in the next couple of years. Indeed, in my judgment these effects are already taking place. I regard the 24- or 25-percent fraction of GNP absorbed by budget outlays as excessive, and I regard 5 or 6 percent of gross national product absorbed by budgetary deficits to be excessive.

As I tried to note in my paper, there is quantitative evidence by a number of economists, a couple of whom I have cited, which argue strongly, and I believe significantly, that large spending and deficits will lead to accomodative monetary policies, rapid money growth, higher inflation, higher interest rates, and over time will tend to undercut the growth in real GNP and the economy.

In other words, I think we are headed for an inflationary course. I trace the analysis of my forecast not from special factors, such as food or energy or wage rates or the like, but from the fundamental fiscal and monetary policy excesses and mismatch, which I believe characterizes our macroeconomic policy situation today.

Now, at the request of the committee's letter to me, I examined the economic forecasts offered to the Congress by the administration in the fiscal year 1985 budget and by the Congressional Budget Office in its most recent series of documents. I find that these economic assumptions are overly optimistic, entirely implausible, and without any credibility.

I think it is remarkable that in the face of record deficits, record spending problems, and the fundamental severe fiscal imbalance we face today, these forecasts by the two leading Government economic agencies actually suggest that in the next 4 or 5 years, in spite of the fiscal situation, we can achieve above-average real GNP growth, considerable declines in the unemployment rate, stable and slightly lower inflation and declining interest rates. I find this to be an absolutely implausible scenario.

It is of note that both of these Government forecasts are quite similar. I am sure in this year's round of budget hearings which I have gratefully missed, there was a lot of discussion and disagreement between the CBO and the administration estimates. They are small disagreements. Fundamentally, both of these forecasts are rosy scenarios in my judgment and disregard the fiscal problem. And I think it is regrettable that these Government agencies are advising the Congress that in the face of this fiscal situation we can generate such a good-looking economic outlook for the next 4 or 5 years. In my judgment we will not be so lucky.

From the standpoint of the projections from my firm, we believe that inflation is right now and will, over the course of 1984, accelerate substantially. As per Geoff Moore's views, I expect the inflation rate to be better than 7 percent by the end of 1984. From the fourth quarter of 1983 to the fourth quarter of 1984, I anticipate an inflation rate increase to about 6.5 percent.

As far as the outyears are concerned, 1985 to 1987, in a trendline sense we project the inflation rate will range between 7 and 10 percent during this period.

Representative MITCHELL. What are those years?

Mr. KUDLOW. 1985 to 1987. I am trying to adhere to the congressional budget resolution's 3-year planning.

The inflation projections by the administration go from 5 to 4.1 during this period. I can only characterize that as silly. And the CBO estimates go from 5.3 to 4.7 percent, and I can only characterize that as slightly less silly. Our view is we are going to 7- to 10-percent inflation. And as I will discuss later, if we have some bad luck with special factors, such as food and energy crises or a dollar problem, we may experience even higher double-digit inflation in the middle 1980's.

As far as real GNP is concerned, importantly linked to the unemployment rate situation, the official Government estimates provide in both cases for a slightly above-average trend growth in real GNP. That is, since World War II, the U.S. economy typically has experienced about 3- to 3.5-percent average growth in real GNP, and applying some normal rules of thumb, this is sufficient to bring the employment rate down. Both the Government projections show real GNP averaging better than the 3- to 3.5-percent trend line over the next 4 years. In the case of the administration, it averages 4.1; in the case of the CBO, it averages 3.8 percent.

I find this to be implausible with such a heavy Federal burden in private market activity as well as financial market activity. Again, I come back to the two key ratios. Outlays will consume about 25 percent of GNP during this period and deficits will consume about 5 percent of GNP. These are historic rates. In my opinion, they are not consistent with strong economic growth, strong capital formation, strong productivity, and the like. Therefore, we believe in the next 4 years the economy will experience below-average or below-trend real economic growth.

I have no particular quarrel with 1984. I think we can get ourselves about 4 percent real GNP. But in 1985, and 1986, and 1987, I believe at best we can get 2 to 3 percent real GNP, or an average of 2.5, which would fall below the post-World War II trend line. And I believe this estimate of somewhat stagnant real output growth is entirely consistent with the severe fiscal imbalance that we face.

As far as nominal GNP and total spending in the economy, I will only note that we anticipate about 10- to 12-percent growth in nominal GNP, for an average of 11 percent. This, in my opinion, is the serious, real fundamental problem in the outlook for inflation. Fiscal and monetary stimulus has already spread through the economy in a much more intense manner than anyone thought a year ago when so many economists thought the economy in 1983 would be very weak, and we are now seeing the effects of this stimulus. We are running at nominal GNP about 11 percent, fourth over fourth, in 1983. Here in the first quarter of 1984, nominal GNP is probably going to run 11 or 12 percent.

We cannot stimulate total demand at 11 or 12 percent against even trend line real output growth of 3 to 3.5 percent and not expect high inflation. And if we have below-trend growth in real GNP against that kind of final demand stimulus, then the inflation rate will be even higher.

What I want to point out is this is exactly the problem we faced in the 1965 to 1980 period, when we had nominal GNP running upward of 9- to 10-percent rates of growth, well above the economy's capacity to produce real goods or services. Consequently, inflation accelerated during the 1965 to 1980 period. In the prior 15 years or so, from about 1950 to 1965, we held nominal GNP growth down to about 5 percent. And so with trend growth of real GNP running about 3 or 3.5 percent, we were able to hold the inflation rate down to 2 percent.

And I note that during a period of slower growth of final demand and average growth of real output, the unemployment rate during this period of low inflation was lower, generally below 5 percent, a rate which if we could achieve again any time soon would be a wondrous economic and political development.

But during the last 15 years, where fiscal and monetary policies stimulated total demand, GNP grew at 10 percent or better and the inflation rate rose, so we did not get a better unemployment situation, we got a worse one. The unemployment rate on a business-cycle-to-business-cycle notation, as pointed out by Mr. Moore, rose to better than 7 percent. We all hope the unemployment rate will be fine in the next 12 months but at least some of us are skeptical.

So my point is that fiscal and monetary stimulus is not the answer to the jobless problem, nor is it the answer to the inflation problem. But regrettably, it is the current policy situation.

My judgment is that the two sets of government economic assumptions are implausible and not credible. Those government forecasts would better fit an earlier time in the 1950's when we had near-balanced budgets, when fiscal intrusion was low, and monetary growth was moderate. But these forecasts do not fit the current setting of macroeconomic policy and, therefore, I think are serving a poor purpose—poorly advising Members of Congress and the public with respect to the likely ramifications and consequences of this fiscal situation.

Now, let me list briefly a couple of additional factors.

We have been very lucky in the last 2 years with respect to two major components in the Consumer Price Index and other general price indexes. One component is food. Food prices have grown by only about 3 percent over the last 3 years. This is a piece of very good luck. I would also note that the U.S. Department of Agriculture, in their official estimates, are now predicting a 4- to 7-percent rate of rise for food prices in 1984.

I concur in the USDA estimates. I think this is unfortunate, but the fact is between the highly stimulative economic policies and something known as the PIK program, once again Government meddling in the private sector is going to produce consequences that no one intended, in this particular case higher food price inflation. That is going to raise the indexes in 1984 and 1985.

Second is energy. We have naturally suffered positive energy shocks in the last 2 years. Indeed, in 1983 the CPI component of energy fell by 1.9 percent. The prior year it increased by only 1.3 percent. These are very fortuitous developments. They relate to the United States, and the worldwide recession which sharply curtailed the price of energy. They also relate to the decontrol of energy prices which I think created better equilibrium between supply and demand, and in general probably strengthened the private markets insofar as energy consumption is concerned.

However, we will not be so lucky in my view in the next 3 years on energy. For one, the U.S. economy is strong, and inflationary tendencies will make our demand situation even stronger. This will prop up the price of energy. For another, overseas foreign recoveries are going to strengthen substantially, both in Western Europe and the Pacific Basin. Leading and coincident indicators are now portraying the likelihood of a strong overseas recovery which also will raise the energy prices as energy demands begin to rise again.

Third, we are always mindful in the energy situation of possible political and military problems in the Middle East. Now, of course, we are beginning to refocus on the Iran-Iraqi situation. This is a matter of great sensitivity and could affect energy supplies and energy prices.

And last, the value of the dollar. The exchange rate of the dollar is very high, as you know. It increased by about 55 percent from its bottom in 1980 to the end of 1983. If the dollar declines this year and next, as is widely anticipated by economists and as recent trends are now beginning to show, this will raise the dollar price of oil and will have a significant effect on the Consumer Price Index and the various GNP deflators. So I am not so sanguine even about the special factors side of the inflation issue. And, of course, as I indicated, I am very concerned about the fiscal and monetary policy factors of the inflation situation.

Last, I wish to underscore what my associate, Mr. Moore, said about the Federal debt problem. We also track this very closely. Mr. Moore's work is very helpful. The leading indicators of inflation, which do not employ monetary variables but instead employ credit variables and employment variables, are pointing to another surge. And this leading indicator of inflation has a pretty good track record, looking back through the years. In fact, the only comment I would make is, if we look at the index from the standpoint of the inflation cycle rather than the business cycle, we are running even more above normal than we have in the past.

So in conclusion, I confess that I do not have a rosy scenario for the committee this morning. I confess to strong disagreements with the government forecasts. I think they are misleading and ill-advising Congress and members of the public with respect to the economic consequences of our deficit predicament. And I fear, though I hope I am wrong, very little has changed in macro policy, and we are about to experience another boom-bust cycle, inflationary boom leading to recession near bust. My indicators suggest what I characterize as stagflation with interest rates rising to 14 to 15 percent in the mid-1980's. But the risks of this inherently unstable scenario are all downside negative risks, and the situation could turn out far worse from an economic interest rate standpoint that even the rather pessimistic estimates that I have presented.

Thank you.

[The prepared statement of Mr. Kudlow follows:]

PREPARED STATEMENT OF LAWRENCE A. KUDLOW

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am pleased to appear before you today to discuss the outlook for inflation and the economy, as well as the credibility of the economic assumptions presented to Congress by the Administration and the Congressional Budget Office.

I. "Classical" View of Inflation.

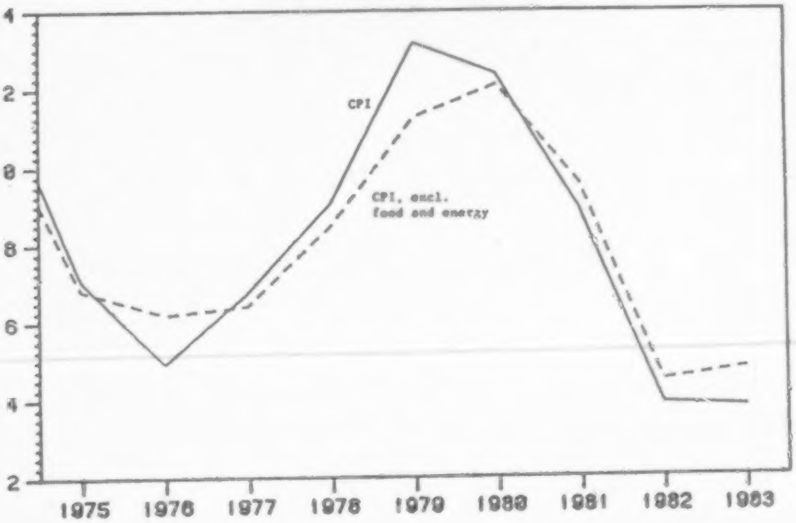
As a general matter, it is my view that inflation over the long run is primarily a monetary phenomenon. If the government (central bank) supplies money at a faster rate than the increase in the private economy's money demand, then the marginal utility (value) of money will decline. In response, the prices of goods and services will rise.

In terms of the U.S. economy, total spending, or demand (nominal GNP) should grow at a rate equal to total supply, or output (real GNP). During the non-inflationary years 1955-65, nominal GNP grew by 5.6% a year, real GNP by 3.5%, and prices rose by only 2.0%. But during the inflationary period from 1965-80, total spending growth was 9.3% per year, real output increased by 3.1%, and prices rose by 6.0%.

The principal differences between the two periods was the significant increase in the rate of money growth, and the increase in total demand, which led to a large inflation increase. Money supply growth during the non-inflationary 1955-65 period was 2.3%, but in the inflationary 1965-80 period it jumped to 6.1%. Real output growth was largely unaffected, changing only from 3.5% to 3.1%. But total demand increased from 5.6% to 9.3%, and inflation rose from 2.0% to 6.1%. Money made the difference.

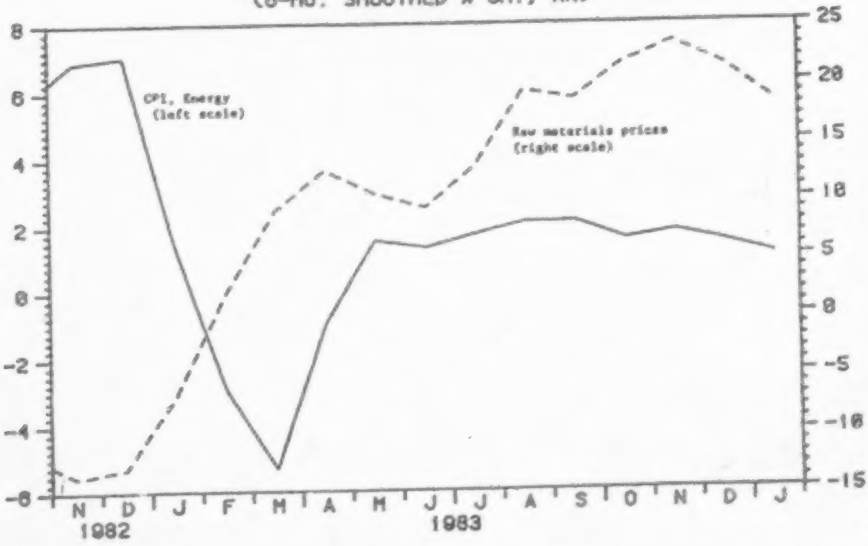
This is not to suggest that money is all that matters with respect to the causes of inflation. Without question, over short-run periods, the prices of goods and services are vulnerable to non-monetary supply and demand changes, or sectoral shocks. Two important examples of this sectoral effect have occurred in recent years in the areas of food and energy. Changes in these areas have occurred independently of shifts in government monetary policies. In 1983, for example, favorable developments in the food and energy sectors contributed to a lower rate of inflation than would otherwise have been the case.

CPI, AND CPI EXCL. FOOD AND ENERGY
(ANNUAL GROWTH: DEC./DEC.)



But it must also be noted that, on an economy-wide basis, some prices will be rising while other prices will be falling. Or, in growth terms, rapid price increases in some sectors may be offset by slow price increases in other sectors. In 1983, although energy prices declined somewhat, raw material prices rose substantially.

CONSUMER ENERGY PRICES AND RAW MATERIALS PRICES
(6-MO. SMOOTHED % CH., AR)



When economists evaluate the overall problem of inflation, the key point is the behavior of the general price level, as measured by the GNP implicit price deflator, or fixed-weight deflator, or the consumer price index. These measures of economy-wide price levels are separate and distinct from observations of specific prices of certain commodities, or goods, or services.

As the data indicate, when nominal GNP growth averaged around 5.5% during the three business cycles between 1953 and 1969, the inflation rate averaged only 2.3%. However, when the rate of total spending grew to 10% during the two cycles between 1969 and 1980, the inflation rate increased to 6.4%.

Table #1
Business Cycles, Peak-to-Peak

	53:2 to 57:3	57:3 to 60:2	60:2 to 69:4	69:4 to 73:4	73:4 to 80:1
Nominal GNP	4.7	4.4	7.0	9.4	10.5
Real GNP	2.2	2.6	4.1	3.9	2.7
GNP Deflator	2.5	1.8	2.7	5.2	7.6
M1 Growth	1.6	1.6	4.1	6.5	6.6

The total demand for goods and services is not the only influence on the marginal utility of money and the inflation rate. Changes in the rate of growth of the supply of output can also affect inflation. This I believe is more in the domain of fiscal policy, where tax changes, Federal budget program changes or regulatory decisions impact the distribution of output between public and private uses, or the mix of private output between consumption and investment. Fiscal decisions (spending, tax and regulatory) significantly affect the efficiency of the economy, the incentive structure of the economy and the productivity of the economy. In today's setting, with outlays expected to absorb about 25% of nominal GNP, and deficits projected to consume 5-6% of GNP, the economy's efficiency and productivity levels will be less than optimal.

But the fiscal effects do not impact real output as significantly as the monetary effects impact nominal GNP or total spending. From cycle to cycle, real GNP growth tends to deviate only marginally from a 3 to 3 1/2% trendline. In the preceding table, real GNP growth fluctuated between 2.2% and 4.1%, a range of only 1.9 percentage points. However, large changes in money supply growth will lead to larger changes in nominal GNP growth. During the five business cycles, nominal GNP growth fluctuated between 4.4% and 10.5%, a range of 6.1 percentage points. Not surprisingly, M1 growth also fluctuated nearly as much, with a range of 5.0 percentage points.

It is also important to note that the demand for money, as represented by the trend growth in velocity (GNP/M1), has proven to be relatively stable from business cycle to business cycle. Of course, within cycles the rate of velocity is capable of significant fluctuations. But on a long-term trendline basis, the velocity link between money and GNP is sufficiently stable as to allow the monetary authorities ample room to limit the growth of the money supply and total spending (nominal GNP) within reasonable bounds. From the standpoint of holding down inflation, velocity growth and real GNP growth are relatively stable. The key to preventing inflation lies with monetary control and the need to hold down the growth of total demand or nominal GNP.

Table #2

Business Cycles, Peak-to-Peak

	48:4 to 53:2	53:2 to 57:3	57:3 to 60:2	60:2 to 69:4	69:4 to 73:4	73:4 to 80:1	Average
V1	4.2	3.1	2.8	2.8	2.7	3.7	3.2

Part of the classical tradition has always emphasized the central role of gold as a means of disciplining the conduct of monetary policy. In earlier times money was redeemable in gold at a fixed rate, thereby insuring current and future confidence in the value of money. The production rate of gold (about 2-3%) governed the rate of increase of money. Under the gold standard the rate of increase of total spending or demand was regulated through a disciplined money creation process tied to the slow rate of increase of gold. Today there is no golden rule or golden anchor -- ever since President Nixon suspended dollar-gold convertibility in 1973. This decision has led to a large increase in the volatility of money growth, total demand and the inflation rate during the past 10 years, but at present there seems little interest in restoring the discipline of dollar-gold convertibility.

In summary, it is the demand side which is the chief inflationary culprit. Supply side factors must not be ignored, but changes in demand are far more volatile. And the key to stabilizing demand at a non-inflationary rate is a disciplined rate of money growth. In terms of the optimal approach to combat inflation over the next five years, money supply growth of about 2-3% would seem about right. With about 3% velocity, this would generate about 5-6% nominal GNP, or total spending, and about 2-3% inflation. Over time, however, a zero inflation rate should be achieved.

II. Forecasts for 1984-1987.

Our economic forecast for the next several years differs in several significant respects from the projections of the CBO or the Administration. Taking account of current fiscal and monetary trends, both of which are highly expansive in relation to post World War II history, we anticipate more rapid inflation, higher interest rates and slower real growth.

We believe that fiscal and monetary policies now in place will lead to inflationary growth of total spending, or nominal GNP, in the area of 11%. In 1983, the sweet spot of the recovery (first year), real output increased by 6.1% and inflation was low. But in future years real output will grow more in line with its historic 3% trend. In fact, because of budget outlays expected to consume around 24-25% of GNP, we expect slightly below trend growth for real GNP.

Therefore, with final demands well in excess of the supply of output, inflation during the next few years is projected to range between 7-10%. Adding to this, we project that interest rates will adjust to the 13-14% area.

Table #3
Economic Assumptions

	1984	1985	1986	1987	Average
Inflation					
(GNP deflator, 4/4)					
Administration	5.0	4.7	4.4	4.1	4.5
CBO	5.3	5.1	4.9	4.7	5.0
L. Kudlow & Assoc. ..	6.5	8.5	8.5	8.5	8.0
Real GNP (4/4)					
Administration	4.5	4.0	4.0	4.0	4.1
CBO	4.7	3.7	3.5	3.5	3.8
L. Kudlow & Assoc. ..	4.2	2.5	2.5	2.5	2.9
Nominal GNP (4/4)					
Administration	9.8	8.9	8.6	8.3	8.9
CBO	10.3	9.0	8.6	8.4	9.1
L. Kudlow & Assoc. ..	11.0	11.2	11.2	11.2	11.1
Unemployment rate (CY)					
Administration	7.9	7.7	7.5	6.9	7.5
CBO	7.8	7.3	7.0	6.8	7.2
L. Kudlow & Assoc. ..	7.8	7.8	7.8	7.8	7.8
T-bill rate (CY)					
Administration	8.5	7.7	7.1	6.2	7.4
CBO	8.9	8.6	8.4	8.2	8.5
L. Kudlow & Assoc. ..	10.1	12.5	13.5	13.5	12.4

The two governmental forecasts are quite similar, and they strike me as implausibly optimistic and therefore not credible. Both assume declining inflation rates, above average real GNP growth rates, and declining interest rates. All this despite the fact that both sets of economic assumptions are based on dismal budget outlooks. The Administration projects outlays during the 1984-87 period to average 23.9% of GNP, and deficits to average 4.8%. The CBO projects budget outlays during the same period also to average 23.9% of GNP, and deficits to average 5.2%.

These governmental agencies would advise the Congress and the public that excessive Federal spending and borrowing are compatible with strong growth, relatively low inflation and declining interest rates. Of course, I do not agree. However, it is no wonder that the legislative and executive branches prefer to postpone the tough political decisions necessary to correct the fiscal problem, when government economic experts are advising that severe fiscal imbalances are compatible with a strong economic performance.

III. Deficits and Money Growth.

In terms of the expansionary thrust of fiscal and monetary policies, I invite the Committee's attention to recent quantitative work by Dewald and Hamburger-Zwick. Both argue that unbalanced Federal budgets and large deficits lead to accommodative monetary policy. In turn, rapid money growth creates accelerating inflation, rising interest rates and below normal output growth. In Dewald's work, he estimates that a 1% rise in the deficit/GNP ratio is associated with a 1.5% rise in M1. This could be expected to generate a 1.5% increase in the inflation rate within 2-3 years. In the Hamburger-Zwick work, the Federal Reserve is expected to monetize between 20-25% of the yearly increase in Federal debt held by the public. The money to inflation lags are also estimated at 2-3 years.

I believe that financial markets recognize the historic link between deficits, money growth, inflation and interest rates. Today, with 30-year Treasury bonds yielding about 12%, the market appears to be predicting 8% inflation. Along with a 4% real rate, higher than usual because of the prospect of a record supply of new Treasury securities, the 12% bond yield is right in line with expectations of higher inflation and continued fiscal imbalance.

	Deficit/GNP	M1 Growth	Inflation	Treasury Bond
1957 - 1965	0.8	2.6	1.7	4.0
1965 - 1973	1.1	4.8	4.5	5.6
1973 - 1981	2.5	6.5	8.0	8.5
1982 - 1987	5.0	8.0(e)	7-10(e)	13-14(e)

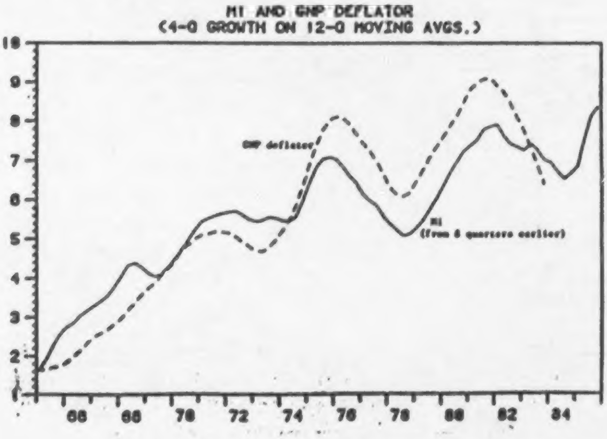
IV. Monetary Trends.

Market interest rates today are high because Federal Reserve policy has been loose, not tight. Indeed, since 1976 the rate of growth of M1 has averaged 8%. This 8% trendline rate was first registered during the Administration of President Carter, but during President Reagan's first three years the 8% rate has been sustained. What's more, since late 1979, allegedly a point of great change in monetary policy, the 8% M1 trendline rate has also been sustained.

Table #4

	Period	M1	Adjusted Monetary Base
(Carter-Reagan)	Q4/76 - Q4/83	7.9	8.0
(Carter)	Q4/76 - Q4/80	7.8	8.6
(Reagan)	Q4/80 - Q4/83	8.0	7.2
(Volcker)	Q4/79 - Q4/83	7.6	7.4

There is nothing magical about M1 growth of 8%. It could be 10%, or 12%, or more. However, 8% M1 growth is clearly inconsistent with the 4-5% inflation rate predicted by CBO and the Administration. During the three business cycles from July 1953 to December 1969, for example, inflation averaged 2.3% and M1 growth averaged 2.4%. I believe that an 8% M1 growth rate will lead to an 11% rate of increase of nominal GNP and a somewhat larger increase of the inflation rate, within a 7-10% range.



The 8% M1 trendline during the Reagan Administration should be divided into two parts. From Q4/80 to Q4/81, M1 grew by only 5.1%. But from Q4/81 to Q4/83, M1 increased by 9.5%. The 1981 anti-inflation monetary policy, along with the disinflationary recession and some very favorable food and energy price results, caused the low inflation rates of the past 18 months. But the monetary situation since mid 1982 strongly suggests a new surge of inflation during 1984 and future years. The Phillips trade-off seems alive and well here in Washington, but the inflation improvement of the past two years may be discarded in the process.

Federal Reserve policy has yet to develop a longer-term strategy to control and reduce the growth of M1, nominal GNP and inflation. These are the nominal targets that should concern the monetary authorities. Not interest rates, or real GNP, or unemployment, or housing, etc. Market confidence will not revive until the authorities publish a multi-year plan to reduce M1 back to 2-3%, GNP to 5-6%, and inflation to 2-3%. Then, of course, the plan must be implemented.

V. Other Inflation Indicators.

Apart from the inflationary nature of current fiscal and monetary policies, several other factors point to future increases in the rate of growth of the general price level. First, food prices have been a benign influence on inflation for the past three years. In 1983 the food components of the consumer price index increased by only 2.6%, following moderate increases that averaged only 3.7% during 1981-82. However, the U.S. Department of Agriculture estimates that food prices in 1984 will range between 4% and 7%. If the 5.5% mid-point is reached, it would represent a doubling of the 1983 rate.

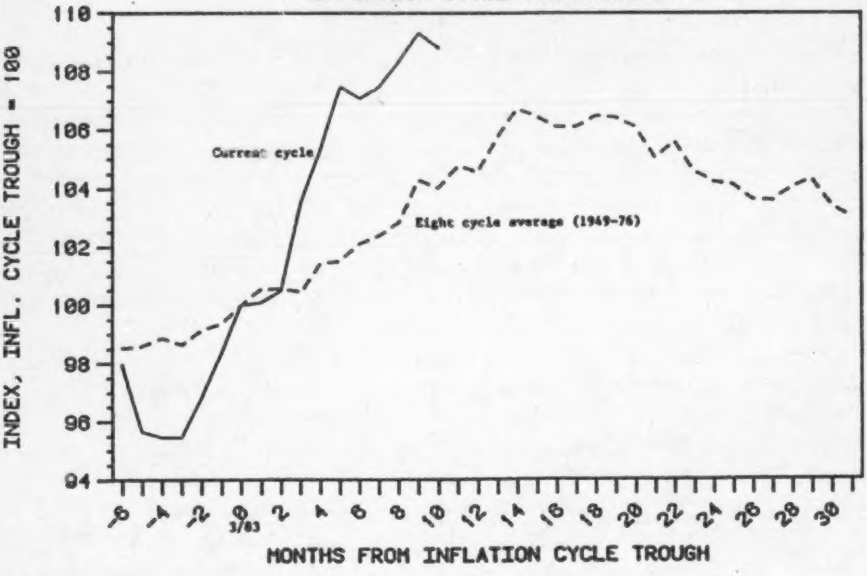
Second, the energy component of the CPI declined by 1.9% in 1983, after registering a small 1.3% rise in 1982. In 1984, the likelihood of further energy price declines is small. Economic recovery will be continuing in the U.S., and world energy demand will benefit from improved recoveries in Western Europe and the Pacific Basin. Moreover, any serious military or diplomatic problems in the Middle East, especially in the Iran-Iraq region, could reduce energy supplies and cause an increase of energy prices. Additionally, the widely anticipated decline in the exchange rate of the dollar, well underway in recent weeks, will raise the dollar price of oil and will add more upward pressure to the CPI and the GNP deflator.

Table #5
Food and Energy Factors
(CPI Components)

	Food	Energy
1983	2.6%	-1.9%
1982	3.2%	1.3%
1981	4.3%	11.9%

Third, a leading index of inflation, which does not include monetary variables, also points toward more rapid future inflation. This index was created by Dr. Geoffrey Moore of the Center for International Business Cycle Research, and it is comprised of three measures: 1) employment rate; 2) total debt growth (Federal, business and consumer); and 3) rate of increase of raw material prices. The growth of this index has been running well above the average of past inflation cycles, and this corroborates the earlier fiscal-monetary discussion.

CIBCR'S LEADING INDEX OF INFLATION (1967=100)
(INFLATION CYCLE COMPARISONS)



VI. Conclusion.

No one can be pleased with a set of economic projections such as I have offered the Committee this morning. Indeed, many of my firm's leading clients are unhappy with these estimates.

However, under present fiscal and monetary conditions, I do not believe that the two government forecasts have suitably informed the Congress of the likely consequences of excessive Federal spending and borrowing, and rapid money growth. What's more, it can be reasonably argued that unless the current fiscal/monetary framework is changed, the economic consequences could be worse. And this is an outcome we would all prefer to avoid.

Representative MITCHELL. Thank you, Mr. Kudlow, indeed they are pessimistic.

I thank all of you gentlemen again, and I could not help but be struck by the fact that it appears that each of you comes to the panel this morning with slightly differing backgrounds and perspectives in economics, and yet all of you arrive at just about the same conclusion—perhaps Mr. Chimerine not quite so emphatically as the other two—but you are arriving at the conclusion that inflation is on the way back up. We thank you for some of your recommendations about how we might prevent this.

Let me suggest that, in my opinion, we do not have before the Congress, nor do I expect us to have before the Congress, any sensible, rational, well-thought-through plan to reduce the budget deficit. I just do not think we have one right now. I do not suspect this to be accomplished in this second half of the 98th Congress.

Let us assume that I am accurate. Let us assume the Federal Reserve will pursue an accommodating monetary policy. In your view, Mr. Kudlow, if this happens, we will see double-digit inflation by 1986 to 1987.

Mr. Chimerine, do you concur with that, that we might get to double-digit inflation?

Mr. CHIMERINE. Congressman, it is possible. I would doubt that we would get to double-digit inflation that quickly. I think people are not focusing on two of the key differences between the likely situation now and what we saw, for example, during the 1970's. And, again, I agree with both of my colleagues here that the trend is upward. I think there is little question about that, despite the administration and CBO forecasts.

I do not think it will be quite as bad as double digits because I think there are two factors that are different from the 1970's when we had double-digit inflation.

First, barring the Iranians closing down the Strait of Hormuz or something like that, we are not likely to see oil prices rise at an average of 35 to 40 percent per year during this decade as they did during the 1970's. Second, while the underlying trend growth in productivity is not quite as favorable as it was 20 years ago, not quite as good as we would like, nonetheless I think it is significantly better than what we saw during the 1970's.

So my own feeling is that the bulge or acceleration in inflation will not go quite as far as I think Mr. Kudlow was suggesting. Clearly, however, if the economy grows too rapidly, if deficits are not reduced, if we have money growth at 10 percent a year plus forever, at some point that is likely to occur. My feeling is that we will not see it quite that quickly.

Representative **Mitchell**. Mr. Moore, would you care to comment on the specter of double-digit inflation?

Mr. **Moore**. I do not want to make any projection of that sort, but I do think and have thought for several years now that there has been a definite change in the attitude of the public toward the problem of inflation. They want to see it licked. And it seems to me, before we actually got to a double-digit inflation situation, that view of the public would probably begin to have some effect on the monetary authorities and other Federal authorities to do something about it.

Now, I hope it would come before that. I think we need to take action now rather than be forced into it later. But I do think there has been a shift in the public view of this matter, and it is certainly against double-digit results.

Representative **Mitchell**. Thank you, sir.

I was quite pleased to hear all of your comments concerning what I consider to be the inflated dollar in the international markets, or the overvalued dollar. It fascinated me because when I put this question to Secretary Regan, he said he just did not know what that meant, an inflated dollar in the international markets.

When I put the question to Chairman Volcker, he said he just did not believe that that was true.

I am a little surprised at the testimony of both of you with regard to the balance-of-trade deficits, because every economist or most economists from whom I have heard suggest that they did not see a trend toward a change in the value of the American dollar. We have about a $70 billion balance-of-trade deficit. Many economists have projected it will reach $100 billion. Mr. Volcker and Secretary Regan, to the best of my knowledge, have indicated that if indeed we devalued this overvalued dollar, it would almost immediately set off another round of inflation.

So you really have a catch-22 situation. I do not think we can let this country go on with a $100 billion balance-of-trade deficit. Yet, I am one who would prod toward some devaluation of that dollar in the international markets.

If we do devalue the dollar, do you see an almost immediate increase in the inflationary rate? This question is to all three members of the panel.

Mr. **Chimerine**. Well, Congressman, it depends how you define "immediately." I think we would see an effect fairly quickly.

Representative **Mitchell**. How quickly? A year? Six months?

Mr. **Chimerine**. Probably a year. You will see some impacts even less than that period. In fact, with respect to commodity prices, it will probably be even faster than that.

I think we are eventually going to see the dollar decline in value. It has to—otherwise the entire industrial sector in the United States will eventually be out of business. There is no way U.S. companies can compete effectively in world markets with a U.S. dollar at the level it is at right now. With all due respect to the Secretary of the Treasury, on a purchasing parity basis or comparing relative costs or relative export prices, the U.S. dollar is now at least 25 percent overvalued on the basis relative to most other currencies, and that is the relative way of measuring it when looking at competitiveness.

If it does not correct, we are likely to see a long-term trend of further declining export shares. I think the bottom is now temporarily being reached, but it is not going to boom. Also we will see continued import penetration.

So I think it will happen eventually. When it does, my own feeling is that the initial impact will likely show up in dollar commodity prices. Obviously, within a short period of time, import prices will rise.

The third impact will be more freedom among domestic producers who compete with those imports to raise prices. We will begin to see effects of this, I think, within a short period of time—not if the dollar comes down 1 or 2 percent; I am now talking about a significant decline in the dollar.

Representative **Mitchell**. To have any impact, it would have to be a significant decline?

Mr. **Chimerine**. That is correct.

Mr. **Kudlow**. The dollar business is a little tricky, I think. I read Secretary Regan's remarks and so forth, followed it with great interest, as I always do. But let me note that you really have to look at the dollar in at least two ways.

It is quite true that the multilateral exchange rate value of the dollar, which has jumped by more than 50 percent in the last couple of years, puts it at a very high level and does cause some distortions in the trade area. This is quite true.

On the other hand, if we partition somewhat the individual currencies against which the dollar exchange rate can be measured, we find the strength of the dollar is not quite as broad as the overall rate suggests. In other words, against the Japanese yen and the Swiss franc and the German mark, the dollar has actually not achieved its exchange rate heights that it achieved in the middle 1970's. It is still below its middle 1970's, and particularly its late 1976 level.

What is distorting the multilateral exchange rate measurement is the very severe decline in the value of the French franc and in the value of the pound sterling, both of which currencies in the last 12 months have, in traders' terminology, gone through the floor. And this caused a big distortion in the overall exchange rate relationships.

But as far as American competitiveness is concerned, I do not believe this is the fundamental problem we have. I think any problems of American labor and capital productivity are essentially homegrown problems. I think it would be unwise for us to launch some kind of protectionist policy wave as a means of competing with European factories and European products and so forth, because I think those kinds of trade policies will only generate a massive worldwide disruption of trade and economic growth.

So I do not look at it in terms of the competitive issue; I look at it in terms of what individual countries are doing with their fiscal and monetary policies. And we have performed better than some and not as well as others.

As far as the outlook for the dollar, I believe the dollar is going to decline in value, not because it ought to under optimum policy circumstances, but because I believe our inflation rate is about to rise significantly, and I believe our growth of real GNP is about to decline. These are the factors that will generate a flow of currencies away from the dollar because the investment opportunities in this country, which looked very good in my judgment in 1982 and 1983, will increasingly look less good. Foreigners are going to be unwilling to invest their money in our Federal debt issuances to cover our deficit if they see that the United States is headed for another round of inflation, and the value of all investments are going to decline in real terms. So they are going to look for alternative investments. This is what is going to bring the dollar down.

Now, if this projection I have made is right—and I am thinking in terms of 10- and 15-percent decline in the dollar this year, 1984—as Mr. Chimerine said, it will have an almost immediate inflationary effect, especially in the commodities area. I want to underscore what I mentioned in my earlier talk, commodities include energy. And it is going to filter right into the Consumer Price Index, and with an additional lag it is going to be felt in the various GNP deflators.

So I guess my view is I do not want to see a cheap dollar policy, nor do I want to see a protectionist policy. But I fear we are headed for a cheap dollar policy with negative ramifications to be inflationary, because of our fiscal and monetary excesses here at home.

Representative MITCHELL. All right.

Mr. CHIMERINE. May I add a point to that?

Representative MITCHELL. If you would hold for just a moment.

Mr. CHIMERINE. Sure.

Representative MITCHELL. I just find it a little difficult to stay with you in terms of fiscal excesses when indeed over the last 3 years, at the request and urging of the administration, the Congress unfortunately slashed away at some of those programs which I alluded to earlier, which are just absolutely necessary for the survival of people.

So if you're talking about whether or not we have cut programs significantly over the last 3 years, the answer is yes, we have—at the request of the administration. And I find it awfully difficult to see how we can characterize that as a continuing fiscal excess. I am just talking about certain domestic programs now. Obviously, that would not apply to the military budget.

Mr. KUDLOW. You and I, Congressman, would probably have a very lively discussion, presumably at another hearing, although if you choose we can have it here, with respect to the priorities of the budget. And I think that is the intent of your analysis at this point.

But I am thinking more in terms of the budgetary aggregates themselves rather than the priority issue. In other words, at the conclusion of the Carter administration, Federal budget outlays were absorbing about 22 percent of gross national product—22 to 22.5 in fiscal year 1980.

At the conclusion of the first term of the Reagan administration, fiscal year 1984, it looks as though Federal budget outlays will absorb nearly 25 percent of the gross national product. So I would argue that we have taken the earlier excess and made it even more of an excess.

In deficit terms, the prior administration budget deficit absorbed about 2.5 percent of GNP in fiscal year 1980, and at the conclusion of fiscal year 1984 the budget estimates for this administration show about 5 to 5.5 percent of GNP. So they have doubled that.

Representative **Mitchell**. In the aggregate.

Mr. **Kudlow**. In aggregate terms.

Priority issues are obviously a much stickier wicket. But I do want to raise the following point, or repeat the following point. It just seems to me in aggregate terms that the notion that deficits do not matter, whether we are talking about real growth or inflation or the dollar, is a silly notion which is unmerited and unjustified by the vast body of economic evidence and analysis.

We are confronted with the peculiar situation where the two leading government projections of the economy are actually suggesting that deficits do not matter.

The point you raise about the dollar's exchange rate is part and parcel of this issue. Deficits will matter. Deficits have, for example, created high real interest rates.

As Mr. Chimerine argued, on a purchasing power parity basis, the dollar looks overvalued, but not with respect to real interest rate differentials among the leading nations of the world economy. The U.S. real interest rates are very high, and one reason they are high is this deficit problem. That, I think, is the real issue.

For Secretary Regan and others to ignore that in their analysis of the foreign exchange situation I think is as misguided and ill-advised as these other economic projections that seem to ignore the deficit problem with respect to inflation and growth. It is all part and parcel of the same problem.

Representative **Mitchell**. Mr. Chimerine, I have one more question, and then I will turn to Congressman Hawkins.

Mr. **Chimerine**. Thank you, Congressman Mitchell. Just a couple of brief comments.

First of all, I do not completely agree with Mr. Kudlow's comments about the dollar with respect to specific currencies, although he is absolutely right, the degree—if I can use that word—of overvaluation varies considerably across currencies. In my judgment, on the kinds of bases we have already described, the dollar is essentially overvalued with respect to virtually every currency, admittedly more so with respect to the French franc and British pound and so forth than is the case with some of the others.

Second, while it is true in many industries, part of our competitive disadvantage reflects the fact that productivity and costs are unfavorable in our domestic industries compared with the foreign competitors. I think steel would be a good example. This is an industry in which average wages are almost twice as high as other industries in the United States, and just about twice as high as their competitors in Japan and other countries. That is their problem, and we do not want to do anything, I think, to relieve the problems as a result of that, but there is no reason to compound that by having an overvalued dollar. And it is, as Mr. Kudlow points out, economic policies in the United States that at least initially caused the dollar to appreciate to the level we have seen in the past year or two.

However, I am not advocating a cheap dollar. But the solution to an overvalued dollar is not an undervalued dollar. I think we need a more fairly balanced dollar in order to make our goods more competitive in the world markets.

Mr. KUDLOW. More stable.

Mr. CHIMERINE. I would like to see a more stable dollar, too.

One last point about deficits, Congressman Mitchell. You talked about spending cuts, and I happen to agree with you completely. I do not think we should be cutting some of the social programs anymore. A strong case can be made in a few of them that we may have cut too far. But one thing I do know: if we decide to keep the programs that we now have, then we have to pay for them. We should have learned a lesson during the 1960's: we cannot fight a major conflict somewhere, cut taxes at the same time, and expect a noninflationary, high-growth environment.

So there are two choices here. If we decide not to cut these programs and if we want to fund the military to the extent the administration desires, then we must start raising taxes to pay for it. If not, we should figure out where we want to cut. The current situation is intolerable because there is no way this economy, as Mr. Kudlow has pointed out, and all three of us have, can perform satisfactorily during the rest of the decade, with the fiscal outlook for rising structural deficits as the economy gets closer to full employment, if that outlook is not changed significantly. Whether this is done on the spending side or the tax side—I have my preference and I am sure we all have our preferences—I think the No. 1 priority is to do it. Specifically how we do it, in my judgment, is less significant at the moment because, if we do not do it, we are going to have serious economic problems in the years ahead.

Representative MITCHELL. Thank you. Now my last question. Generally we are in agreement, I think, that something has to be done about the deficits. I do not think a huge deficit is meaningless. I think it is very foolish to think along those lines. But I am a little concerned that in the testimony of all three of the witnesses there was little, if any, attention paid to the matter of employment or unemployment.

We have a deficit. Unemployment rates remain dangerously high, in my opinion. And if you take the most conservative estimate that every 1 percent of unemployment costs about $22 billion a year, then it would seem to me the more logical approach would be for this Nation to focus on reducing the unemployment rates which are admittedly so devastatingly high.

I say that only because there was an indication if we could get to full employment—and you were talking about 6 percent—is that what you mean?

Mr. CHIMERINE. Yes.

Representative MITCHELL. Something I have never been able to understand is how 7 million people out of work represents full employment. Even if unemployment gets to 6 percent, this is still a very humane nation and it is going to take care of people out of work. And 6 percent at $22 billion for 1 percent is obviously a major contributor to our deficit.

Just for the record, I am a little concerned that there has not been much of a focusing on that problem which obviously creates a great deal of difficulty in creating and sustaining a huge deficit.

Mr. CHIMERINE. Congressman, I would like to respond to that because I think that issue indirectly has been addressed. I think all of us feel very strongly—I know I do—that, if the imbalance in the deficit is not eliminated or reduced and future deficits are not reduced significantly and put on a downward trend, then one of two things—or both, in fact—will happen during the next several years: Either we will have much higher interest rates, as I believe is very likely, or we will have much higher inflation if the Fed accommodates those deficits. Perhaps some combination of the two will occur. In my own judgment, that will ultimately mean much higher unemployment. I think the solution to lower unemployment is to reduce future deficits so that interest rates will come down and not rise further during the next several years, preventing some of the resurgence in inflation that is possible if these deficits do materialize. Under those conditions, most other fundamental factors would suggest that we could have sustained economic recovery for several more years and further reductions in unemployment.

So I think that, when we all talked about reducing deficits, particularly the structural component that is built into the current deficit outlook, we are indirectly addressing employment or unemployment because it is my feeling that that will be the biggest obstacle to further reductions in unemployment during the next several years.

Representative MITCHELL. Congressman Hawkins. And thank you for indulging me.

Representative HAWKINS. Let me begin with that last point which is a rather amusing sense of compassion for the unemployed, that we reduce the deficit so as to reduce unemployment.

It seems to me, Mr. Chimerine, that is upside down economics, that you are making the reduction of unemployment contingent on reducing the deficit when unemployment did not cause the deficit.

So it seems to me you are avoiding the real causes of the current deficits which were brought about obviously as a result of the 1981 Tax Act, as a result of high interest rates, which relates to the Federal Reserve Board's policies, to the excessive expenditures on defense weapons, and so forth. If would seem to me if we analyzed why the deficits have taken place in the last few years, we get down to these causes, including something which I think you did indicate; that is, the recession which obviously meant a lot of unemployment and idle plants and increase in spending on entitlements and so forth.

It would seem to me that in making deficit reduction the primary economic activity today does not get us to the basic causes of why we have the deficits in the first place.

Mr. **Chimerine**. I think it does, Congressman.

Representative **Hawkins**. In other words, I think it is a matter of primary interest. You start out with the deficits, and I start out with what I think is the primary purpose of economic activity, and that is to produce goods and services and have them distributed so that we can enjoy the things we desire and need as a people, and not the other way around.

Mr. **Chimerine**. I agree with you, and I also agree with you about some of the causes of the current deficit outlook. I think the tax cuts in 1981 were too big, quite frankly, in view of the military buildup that is now underway. And I think some of that is going to have to be reversed. But that is exactly my point. This world is not linear, Congressman. Bigger and bigger deficits and bigger and bigger tax cuts and spending increases do not always stimulate more economic activity. Eventually, they are going to exert significant pressure on financial markets; higher interest rates, some of which we probably are already seeing—I think we are going to see a lot more in the years ahead—and perhaps more inflation. And that combination will have the opposite effect of what was intended. It will ultimately slow the recovery process, probably produce another recession and even higher unemployment, and, as a result, even higher deficits.

So I do not think we have a basic disagreement as to what caused the deficit or what should be done about it. In fact, if we put future deficits on a downward trend by some spending cuts or tax increases or some combination of the two, I do not think we are eliminating all the fiscal stimulus that is embodied in the current program. Quite the contrary. A gradual declining pattern of future deficits during economic recovery will still provide ample fiscal stimulus for continued economic recovery and avoid the risk of higher inflation or higher interest rates, which could abort the economic recovery. So I do not think we have a fundamental difference.

Representative **Hawkins**. Let us reverse it and let the other two witnesses answer it as well. Assuming we admit deficits are indeed a problem, without at this time fixing the blame necessarily on what caused it in the first place, how would you go about reducing it? How would you go about achieving the economic growth that you think would be necessary to avoid another recession and to get us back to a healthy economy rather than a sick economy?

And in replying to that question, can we break it down, not say that we need to deal with monetary and fiscal policy. Let us be more specific. If we are going to have a restricted fiscal policy, as has been mentioned several times, let us be specific. What type of spending cuts are we talking about? And if we are going to have a restricted monetary policy, let us deal with that in terms of specifics rather than refer to these—I appreciate that you may not want to break it down to be too specific, but that is precisely what we have to do. Everybody has talked about spending, including the administration, excessive spending. Yet, they are spending more than we ever dreamed of spending. Even under the Carter administration with his policy of fiscal austerity, we caused the President to take his budget back and bring it back to us, saying, "If you think it should be cut, you make the recommendations."

So I think we have got to be more specific. We cannot just say spending cuts happen to be the cause of our difficulty when out there a lot of people are unemployed. We have less housing, we certainly have less health care, and all the things that make for decent living for people. Are we going to continue to cut these and say as a great nation we cannot afford to do these things, and that we have to worry about the deficits.

I think we have to be a little more specific. And I would appreciate, since I think the witnesses are able economists, to get down to making sense out of what we are talking about—not that you have not been talking sense; I think these are three of the best witnesses we have had before this committee—but I think we have to be specific in terms of: if we are going to cut, what are we going to cut? And if we are going to spend, as we should be spending in some of these fields—we cannot cut everything. The President himself suggested some expenditures in outer space. Now, he certainly feels that some places we should be spending as a nation. Maybe we should be spending to defend ourselves more but, as I think you, Mr. Chimerine, indicated, where are we going to get the money?

So could we be a little more specific and see how we are going to reduce the deficit, balance the budget, take care of human needs, and avoid inflation by being a little more specific even on that, as to what type of an anti-inflation program are we going to have, rather than merely creating unemployment and recession to fight inflation.

Mr. CHIMERINE. Yes, Congressman, let me quickly answer that. I think there were three essential points, and I will try to answer your question directly.

First of all, you used the word "restricted." I do not think that slowing the growth of spending in the future or scaling back some of the tax cuts would result in a restrictive fiscal policy. In my judgment, it would correct the problem of an excessively stimulative fiscal policy. And there is a major difference between the two. So I am not talking about massive changes, particularly in the short run, that would likely produce another downturn, because it would be not only eliminating whatever fiscal thrust we now have, but would produce a very restrictive fiscal policy.

My judgment is that current programs, if they materialize, will cause so much excessive fiscal stimulus that it will become self-defeating by its effect on inflation or interest rates. If we make the kinds of cuts I am going to suggest, we would still have an acceptable fiscal policy to promote additional economic growth.

Second, you yourself mentioned—and I think Mr. Kudlow mentioned, and you are obviously both right—spending is higher now than it has ever been before, despite the efforts of this administration to cut programs. Neither the administration nor the Congress has cut spending. You have cut some spending programs, but those cuts have been swamped by increased spending elsewhere, particularly obvious for national defense, for interest on the national debt, and for the cost of many entitlement programs, which are still skyrocketing. So all you have done is displace some expenditures by increased spending elsewhere. Total spending has not been cut.

When we talk about cuts, I do not suggest any additional cuts in most of the typical kinds of social, people-oriented programs. What I think has to be done is to reduce the growth in expenditures in two key areas—one, defense—and I am not a military expert but it is hard for me to believe we need all this expenditure for the military that has now been built into future budgets—and second, I think we must slow the growth in entitlement expenditures in the future. And the two key areas would be health and pensions, in my judgment.

In the pension area, as I mentioned earlier, I would scale back the cost-of-living adjustments for social security. I would introduce a means test for social security benefits. I would move to a later retirement age as soon as possible—perhaps 70 years old—phase it in as quickly as we can. I think we have to cap the growth in medical costs and the costs of health care programs and, quite frankly, I think pensions for Government workers are growing too rapidly. They are completely indexed, and I do not think we can afford that in the United States.

So area No. 2, after defense, would be entitlements, and, after those are done, I would ask: How much have we cut the military? How much have we scaled back the growth in entitlements? How much do we save on interest expense on the national debt by doing so? And then, using reasonable economic assumptions about future economic performance, I would compare the kinds of deficit outlook we have after those changes with what we would like to see—and I would suggest tax increases to make up the difference. And I have my own view as to what type tax increases we should be looking at, and, if you want I would be delighted to talk about it.

But, by and large, I think that is the process. Let us cut the growth in entitlements and defense, see what we have done, and, after we have done that, what else do we need on the revenue side to make up the difference between an acceptable pattern for future deficits and what would those changes produce?

Representative **Hawkins**. I just want to get one clarification and then allow the other witnesses to answer the same question.

In terms of entitlements, by their very nature, they are things which people are entitled to as a result of adverse economic conditions.

Now, assuming that economic policies may be misguided and create recessions, certainly monkeys do not do it and people in outer space do not do it; we do it down here on Earth. We caused the recession, obviously, and slow economic growth in order to fight inflation.

Now, you are saying in effect, it would seem to me, that those who are entitled to certain increases in their benefits, as a result of recessions that they do not cause, are the ones who should suffer. Now, I do not know why——

Mr. **Chimerine**. I am not saying that at all.

Representative **Hawkins** [continuing]. We should not reduce the need to qualify for these entitlements rather than tamper with the benefits that come as a result of adverse economic circumstances.

Mr. **Chimerine**. I agree with both.

Representative HAWKINS. Other than that, I agree with everything else you have said.

Mr. CHIMERINE. But, again, I was not talking about the types of programs that are very sensitive to economic conditions. I was not talking about further cuts in unemployment benefits or food stamps or training or nutrition programs. I am talking principally in the pension area, which has very little to do with the state of economic conditions and with the cost of health care. While, admittedly, there are many poor people who depend on those health care programs, I would attack the problem not by reducing the number of people who are eligible for them but by taking steps that would slow the growth in the cost of health care.

So in no way would I want to deny benefits to people in need either now or during recessions. Quite the contrary. I think I would go after the programs that would not do that.

Representative HAWKINS. Thank you.

Mr. Kudlow and Mr. Moore, would you care to address the same question?

Mr. KUDLOW. I knew I would not get out of here without the budget battle, having participated in it for 3 years. It is a little easier on the outside than it was on the inside, but since you asked, I think the first question that has to be answered is: What is the size of Government that is most desirable? That is not a small issue.

The Reagan administration, in the white paper issued in 1981, sought to balance the budget in 1984 at 19.6 percent of GNP. Let us call it 20 percent of GNP.

As we look at the situation today, we are going to have budget outlays of about 25 percent of GNP in 1985 or 1986—from 1984 through 1986—a realistic economic projection would get us to about 25 percent of GNP.

The first question has to be answered on the spending side and it relates to taxing: How big a government do we want? My sense is 25 percent is too high. The original target of 20 percent is probably too low. It is an impossibility in my judgment, and I daresay my former colleagues at OMB would agree—20 percent is just too low.

Suppose we want to look at the 22- to 23-percent area, someplace in between. Beginning on the spending side, yes, I think we must revisit and reopen the issue of the very generous retirement benefits in the budget.

Now, on this point, Congressman, I believe we have got to needs-test or means-test in many of these programs. I do not believe we should tamper with the low-income recipient. It is in that area where the greatest political and economic sensitivities exist. And I am very sympathetic to what I take as your views on this.

But there are a lot of people who are getting social security benefits, who are getting medicare benefits, who simply should not have the volume of benefits, either current or prospective, because they can afford it. And I am not even speaking of marginal people. I am speaking of people who are well into what any reasonable analyst would describe as middle income and upper middle income and upper income areas. I do not think we are in a position in the U.S. economy today where we can afford to be as generous as we have been. There are too many constraints on the budget.

So I would like to see some means tests or needs tests apply in these areas—medicare and social security.

I also believe that the medicare system is due—and already activity has begun here in Congress in this session and the last session and presumably future sessions to reevaluate from the standpoint of management, efficiency, cost control, reimbursements, and all the rest. And I think this will move forward in due course. On the other hand, I also feel there is a revenue shortfall on the health insurance and I think that is going to have to be dealt with in the next couple of sessions of Congress. Otherwise we are going to run out of dough, and we may be closer to that than we realize. So I would start there.

I would also take a very hard look at retirement plans for civilian and military Federal employees. And in that particular regard, I think that many of the retirement policies are excessively generous. We are talking in the main—and here is where the needs test-means test idea might enter again. Many of these individuals who are hard working, very intelligent, well educated—they will do quite well in the private sector should they seek to choose private-sector employment—I am thinking especially here in the military area. They are valuable, desirable, labor market people. I do not think we need to be as generous, and I know we cannot afford to be as generous. So the issue of civilian and military retirement is very important.

There is another area that we have not discussed this morning, and that is the area of agriculture price supports and subsidies and subsistence programs in general. Here, too, there are some sectors of agriculture that need and deserve Federal assistance. But there are many sectors of agriculture where we have simply gone too far. Whether it is straight cash payments, whether it is below-interest-rate loans to the CCC, whether it is crop price supports or whether it is loan guarantees, we have simply gone too far. I estimate that on a cash basis as well as an in-kind basis, including the PIK program, this administration has been excessively generous in the agriculture area to the tune probably of about $8 to $10 billion. And many of the recipients of that are unpoor. We are talking about corporations and well-to-do landowners and individual farmers, and so forth, where we need not be so generous, and I think we should reopen the issue of agriculture subsidies.

Then on the military side, apart from military retirement practices which I have already indicated in my view are too generous, I favor by and large the President's foreign policy. That should come as no surprise. But I also believe that the recommendation by former President Ford with respect to stretching out the programs ought to be very carefully considered. I do not find myself quite as sympathetic to the notion we can budget the military side simply quantitatively in terms of some sort of real outlay rate of increase.

Senator Domenici's proposals—and there is no one in the Congress who has fought harder for fiscal responsibility than Senator Domenici—which have been much in the press in the last 2 or 3 days, I think, in a sense are unwieldy from the standpoint of conducting military foreign policy.

I do, however, feel on a weapon-by-weapon, readiness-by-readiness, division-by-division sense, we need to see whether we can achieve similar or essentially the same military and foreign policy objectives in a longer time period so as to slow down the rate of spending in the next 5 years when we need the budgetary savings. So I am in favor of military spend-down.

Now, in addition, on the tax side, we are going to have to raise taxes. Conservatives do not like to raise taxes, but we are going to have to raise taxes if we want to get to even 22 or 23 percent of GNP, because right now the tax yield is less than 19 percent of GNP.

Now, in my view the Congress has moved in the last 4 or 5 years in an appropriate direction to try to improve saving, investment, and capital formation incentives, thereby bolstering the outlook for real growth in employment. I think this has been appropriate, and this has been a bipartisan movement as best I can determine. Although some individuals disagree with specific items, by and large this is a direction of congressional policy.

I would not reverse that direction. In seeking additional revenue yields, I would move in the direction of some kind of consumption tax approach, sales tax approach, excise tax approach, or, pardon the phrase, value-added tax approach. I prefer to look at it as a consumption tax because value-added tax has bad political connotations because of certain former members from the western part of the United States. But I believe in effect we are going to have to come around to that.

Representative HAWKINS. After the election.

Mr. KUDLOW. After the election, yes, sir. I am not as naive as when I first showed up in these hearings a few years ago.

In addition to that, on the revenue side, I would like to take a look at what is known as the tax expenditure list, which is part of this wondrous document [indicating], and go through that with a fine-tooth comb, again applying the criteria of the means test or needs test. There are a lot of tax preferences, credits, subsidies, and the like that go to upper middle and upper income and corporate entities that do not need that kind of generosity to perform well and be productive and where we cannot afford that kind of generosity. So I think tax expenditures, plus some kind of consumption tax, plus my spending arguments, and in fact if we wanted to get even more specific I could pull out a list and give you the numbers.

The last point I want to make, which in my own view is the most important point, is we have a problem that Mr. Moore referred to, and that is the problem of Federal debt. I want to look at it from a political budgeting standpoint. The most abused rule in the Federal budgeting process is the at least twice-a-year effort by the Congress to raise the debt limitation ceiling. I think this is the root of all evil. And I say that because as long as we know we can always raise that debt limitation ceiling and always fund these programs to the issuance of more deficits, we will never undertake the discipline in spending and taxing to avoid this debt problem. And I believe the debt problem is very close to the center of the dismal economic outlook that at least some of us have argued here.

Now, whether you do it through the debt limitation enforcement or other statutory actions, I find myself not particularly thrilled about constitutional amendment. I think the Congress has sufficient legislative and statutory power to do it. But my sense is as long as we open the debt limitation door, we will never create a discipline on spending and taxes. And what this budget process needs, if nothing else, is discipline.

Now, the last point, on inflation. I do not believe that fiscal excesses are by themselves a sufficient explanation for either the past inflation we have suffered or the prospective inflation rise that I have predicted.

I believe monetary policy is deficient in some very important areas. And perhaps the tip of the iceberg and the most important area is we must employ monetary policy to restrain the growth of aggregate demand and total spending in the economy.

I mentioned in my opening remarks that nominal GNP aggregate spending cannot rise 10, 11, or 12 percent a year without generating inflation. Even the most brilliant fiscal policies, even the most supply-side—pardon the phrase—policies that we can all agree on, will not raise real GNP much more than a half a point or a point over time. It does not fluctuate that much. We run up against all sorts of capacity restraints and the like. What we can restrain is nominal GNP, and that has to get down to the 5- to 6-percent area to hold inflation down. That, in my opinion, is a monetary function far more than a fiscal function. But if we put the two together, shall we say, more balanced budgets and a more restrained monetary policy, what we will do, in my estimation, is we will keep the low inflation we have today, maybe bring it down lower, and that is the key to lower unemployment. In my view, the single largest barrier to getting the unemployment rate down to the 4- to 5-percent area we experienced in the 1960's—the single largest barrier to achieving that highly desirable objective is the inflation problem. It is a mixed bag but it is a total package.

Representative **Hawkins**. Mr. Moore.

Mr. **Moore**. I would like to associate myself with Mr. Kudlow's remarks. I think I agree virtually 100 percent with his proposals.

Let me just add one thing about the means-test idea on entitlement programs—and it is simply a personal experience of my own.

A week or two ago I got a notice from the Social Security Administration saying since I had reached the ancient age of 70 this month I was entitled now to get payment for social security. I do not need those payments. I work. I have a job that is a pretty-well-paying academic-type job. I am perfectly satisfied to get along without the social security payments to which I am now entitled.

But it seems to me that there must be many more people in this country besides myself in exactly that position. And if some sort of means test were applied to people in that situation, I think the Federal Government could save a great deal of money, and it would be one way of alleviating the problem.

Let me revert, if I may, to the proposal I did make, namely that the Congress fix a limit on the growth rate in percentage terms of the Federal debt, defined in some specific way, year by year. If some emergency came along, such as a war or a recession, which required a larger growth rate, that could be accommodated. But in most circumstances—and I would think right now would be one—where we do not need, from the point of view of the economy or the needs of the population generally, a large increase in the Federal debt, there would be a restriction on it.

It seems to me that is one concrete idea. It may not go all the way that we need to go to decide just how to accommodate ourselves to whatever that fixed percentage is, but at least it is a step in the direction of producing a limitation.

Representative HAWKINS. Thank you, Mr. Moore. I appreciate your very personal remarks.

May I say I reached that age, too, and I receive a social security benefit. And I will give mine back when those who got the generous 1981 tax handout begin to give theirs back. When they begin to give theirs back, I will begin to give my social security back.

Mr. CHIMERINE. Along those lines, Congressman, may I make one or two observations. I think all three of us have basically said the same thing about the entitlement programs, that cuts that are made while slow of growth should be focused on those benefits accruing to people in middle incomes and above rather than on low-income individuals, primarily through a means test.

I disagree with Mr. Kudlow, though, in a couple of areas, for one, on the military buildup. I do not think the solution is stretching out, because all you would be doing is deferring the problem to some extent. To some extent, it is going to be higher unit costs, so you are not going to save all that much. Ultimately you are going to have to make up your mind that you are going to have to cut out certain programs. If you really are serious about cutting or reducing the growth of military, you are going to have to make significant changes in some of the existing programs that are currently planned.

On the tax side, I guess I have a strong disagreement with Mr. Kudlow. It seems to me, as you suggest, Congressman, that one of the things that has happened in the United States in recent years is that there has been a dramatic shift in the distribution of the tax burden, away from the people in upper incomes, and toward people in the middle- and low-income groups, not just because of the 1981 Tax Act. We have balanced that off with increases in very regressive social security taxes, in increases in relatively regressive taxes, sales taxes in many States and local goverments around the United States, and current trends that, in my judgment, will make the tax structure even more regressive in the years ahead, particularly the large social security tax increases that are scheduled during the rest of this decade.

I think that one of the objectives of any tax increases—and there should be several—that are adopted as part of a budget-reducing package should be: First, to make sure that the tax system is not made more regressive in the years ahead; if anything, some of the recent change can be reversed. Second, I think there has been a dramatic reduction in the corporate tax burden, and I think that should be altered. One way to do that would be to implement some kind of a minimum corporate tax, because there is also a wide variation in the corporate tax burdens across industries in the United States.

I am not in favor of a value-added tax, not only because it has the potential of adding regressivity to the tax structure; it would be inflationary. If it is put on over the next year or two when inflation is already escalating, and then with the cost-of-living adjustments and wage-price spiral—and despite what Mr. Kudlow said, I do not think the evidence is very persuasive that a value-added tax stimulates savings.

So, in my judgment, it ought to be on the income tax side. The way to do it is not to raise marginal taxes, but, as Larry points out, to eliminate some of the tax shelters, tax expenditures, and other things, particularly those that accrue to middle income and upper income people, in effect broadening the tax base. That is where the revenue should come from in my judgment.

Representative **Hawkins**. Thank you, Congressman Mitchell.

Representative **Mitchell**. I want to thank all three of you gentleman. The bottom line is there is consensus that unless something is done, we will see an increase in inflation. The one thing that is most appealing to me was in a statement made by Mr. Chimerine, and that is, although I do not agree with the total dollars that you are talking about, that we reduce the Federal deficit over a period of time. I think you indicated $30 billion a year based on the proceeding year. That might be a little high. But I was so glad you said that because all of us in the Congress and outside of the Congress have to disabuse our minds of the idea that somehow miraculously we are going to reduce this debt in 4 years or 5 years. It is simply not going to happen without imposing enormous hardship on millions of American citizens.

So I am with you on that, that the deficit does present a problem. But any kind of blunderbuss approach is simply not acceptable. And as long as I am in the Congress, and even when I leave the Congress, I am going to be, strangely enough, talking about gradualism in terms of reducing this deficit.

Gentleman, thank you very much for a very stimulating presentation on the part of all three of you.

The committee is adjourned.

[Whereupon, at 11:58 a.m., the committee adjourned, subject to the call of the Chair.]

[The following statement was subsequently supplied for the record by the American Council of Life Insurance:]

STATEMENT ON ECONOMIC POLICY ISSUES OF 1984

Submitted to the Joint Economic Committee of the Congress
by the
American Council of Life Insurance

February 24, 1984

This statement is submitted on behalf of the American Council of Life Insurance, a national trade association with a membership of 597 life insurance companies which account for 95 percent of the legal reserve life insurance in force and 94 percent of the total assets of all U. S. life insurance companies. At the end of 1983, total assets of the life insurance business aggregated more than $658 billion, invested mainly in corporate and government securities and mortgage loans to businesses and individuals. These funds represent the savings that have been entrusted to our business by millions of individual policyholders and employee benefit plans. We are pleased to have this opportunity to present the views of our business to the Joint Economic Committee in the course of its deliberations on the U. S. Budget for the Fiscal Year 1985 and the Economic Report of the President, February 1984.

The Problem of the Deficit

The unprecedented size of present and projected federal budget deficits is one of the major problems requiring policy action by the Congress and the Administration. As shown in more detail later, the magnitude of these deficits is such as to cause real interest rates to rise and risk a return to recession within the next two years. These deficits are also a major factor contributing to the overvaluation of the dollar, to the consequent burgeoning of the U. S. trade deficit, and to aggravation of the severe debt problems of developing countries. Early action is required to meet this fiscal crisis. Postponing action to 1985 or 1986 would greatly increase the risks of renewed inflation and recession in the domestic economy and of disrupting international financial relationships.

The President has proposed a bipartisan effort at a $100 billion "downpayment" on a deficit reduction program over the next three years, but in our view, this goal is set much too low. The Administration's Budget for 1985, which partially reflects the $100 billion downpayment proposal, projects a series of budget deficits on the order of $180 billion over the next three years with a decline to $152 billion in 1988 and $123 billion in 1989.

This progression of deficits would be serious enough if we could accept the budget figures as realistic. But the outlook is actually considerably more disturbing, because the long-term economic assumptions used in the budget document for fiscal years beyond 1984 are based on a very optimistic view of the economy, as indicated in the following table:

Economic Assumptions Used in the 1985 Budget

Calendar year	Real GNP	Price deflator	Unemployment rate	91-day Treasury bill rate
	(Percent	change)	(Annual average)	(Annual average)
1984	5.3%	4.5%	7.8%	8.5%
1985	4.1	4.8	7.6	7.7
1986	4.0	4.5	7.3	7.1
1987	4.0	4.2	6.8	6.2
1988	4.0	3.9	6.1	5.5
1989	3.9	3.6	5.7	5.0

While the Administration forecast for 1984 is close to that of most private economic forecasters, its assumptions for the 1985-1989 period are not at all realistic, in the view of both many private economists and the Congressional Budget Office (CBO). The Administration's projected decline in the Treasury bill rate to 5.0 percent is particularly suspect. Investment officers and economists in the life insurance business are forecasting significantly higher interest rates, more in line with those contained in the recent report of the Congressional Budget Office. The CBO forecast and its associated more conservative economic assumptions are as follows:

Economic Assumptions of the CBO

Calendar Year	Real GNP	Price deflator	Unemployment rate	91-day Treasury bill rate
1984	5.4%	4.7%	7.8%	8.9%
1985	4.1	5.1	7.3	8.6
1986	3.5	4.9	7.0	8.4
1987	3.5	4.7	6.8	8.2
1988	3.4	4.5	6.6	8.0
1989	3.3	4.3	6.5	7.8

If interest rates were to remain at the higher levels assumed by the CBO, as seems more realistic, the interest cost of the debt would compound very quickly as these higher rates are applied to the rapidly growing total outstanding debt. The CBO's "baseline" projections of interest are shown below in comparison with the 1985 Budget projections on a current services basis.

Interest Costs in the 1985 Budget
(Amounts in billions)

Fiscal Year	Projections in 1985 Budget: Treasury bill rates (1)	Projections in 1985 Budget: Interest cost (2)	CBO assumptions: Treasury bill rates (3)	CBO assumptions: Interest cost (4)	CBO assumptions: Difference (4)-(2) (5)
1983	8.6%	$ 90	8.6%	$ 90	-
1984	8.5	108	8.9	108	-
1985	7.7	118	8.6	127	$ 9
1986	7.1	129	8.4	145	16
1987	6.2	138	8.2	168	30
1988	5.5	140	8.0	194	54
1989	5.0	138	7.8	219	81

Source: Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1985-1989, February 1984, p. 12.

A doubling of the interest costs in five years from $108 billion in 1984 to $219 billion in 1989 ($81 billion more than projected in the 1985 budget) would swamp proposals for cost savings in other parts of the budget.

In short, the federal budget is now growing more rapidly than GNP and will continue to do so except under the unrealistic long-term assumptions used by the Administration. At the same time, budget receipts are growing only at about the same rate as GNP. The result is that the long-term outlook is for an enlarging deficit, not a declining one, and the "down-payment" approach for a $100 billion reduction over three years will not begin to meet the problem.

Major Expenditure Components

The particular expenditure items that contribute most notably to the sustained high level of prospective budget deficits are increases in defense outlays, interest costs, and medicare benefits. Outlays for national defense are estimated to rise 14.5 percent in nominal terms, and 9.5 percent in real terms, during 1985. Despite the need for a stronger national defense, an increase at such a rapid pace is not compatible with efficient growth in defense programs. Moreover, expansion in the largest component of the budget at this unprecedented peace-time rate will make it more difficult for Congress to achieve realistic savings in other parts of the budget. In short, the pace of expansion in proposed defense outlays seriously aggravates the deficit and in so doing accentuates the dangers a large deficit portends for the economy.

The social security program was at least temporarily taken care of last year, and its growth has slowed since then. However, because of the rapid growth in outlays for the medicare program, there is a serious question how such outlays can continue to be financed. Medicare spending is expected to rise from $52.6 billion in fiscal 1983 to $84.8 billion in fiscal 1987, which represents an average annual rate of increase of 13 percent. If not curbed, this rate of growth in medicare outlays will soon produce a crisis in the program.

Because of the continuing large federal deficits and the resulting rise in total debt, interest costs have become the third largest component of the budget (after defense and social security). In the Administration's budget, net interest is expected to rise to $116 billion in fiscal 1985, or 3.0 percent of GNP. This contrasts with an average ratio of interest to GNP of 1.6 percent in the years 1970-1979 and 2.6 percent in the years 1980-1983. In future years, interest on the debt, in the Administration's projections, would continue to rise approximately in proportion to GNP. But if more realistic assumptions are used, interest costs would rise as a proportion of GNP and become an increasing obstacle to meeting the deficit problem.

Policy Recommendations

The Council recommends a number of policy goals and actions to meet the crisis in federal finance:

(1) To make sufficient progress in coping with the federal deficit problem, the Administration and Congress should aim at cutting the annual deficit in half. This means a deficit reduction program of approximately $100 billion a year. To reach that goal requires cutbacks in both defense and nondefense programs as well as increases in general revenues.

(2) The need for a strong national defense is clear, but the first requirement for a strong national defense is a strong economy. Unfortunately, the high rate of increase in defense outlays recommended for 1985 and the years ahead will contribute to huge deficits which jeopardize the prospects for sustained economic growth. We therefore recommend a scaling down in the rate of growth of defense outlays and a stretching out of military programs as a means toward achieving deficit reduction. Without this basic step, it is difficult to believe that the Congress and the public will support other measures needed for a truly effective overall deficit reduction program.

(3) In the absence of a substantial deficit reduction, rapid growth in the outstanding federal debt will lead to an exponential growth in the interest cost burden on that debt, outrunning efforts at deficit reduction elsewhere in the budget. At a minimum, the goal should be to hold the deficit to a level at which the burden of interest payments will not be growing in relation to the economy.

(4) Curbing the rapidly growing outlays for medicare is essential, and that will require a concerted effort to control services and costs.

(5) We have examined the Report of the President's Private Sector Survey on Cost Control (Grace Commission), and we believe that the Report serves two valuable functions:

  (i) It identifies areas where meaningful economies and improved efficiencies can be realized (which we believe should be actively pursued by the Congress and the Administration).

  (ii) It demonstrates that hard choices must be made through extensive legislative action, especially in the areas of entitlements and defense spending, if the majority of the savings programs outlined in the Report are to be undertaken.

While we should not lose sight of the many meaningful recommendations made, the Report's overall conclusions leave an impression that they will solve the whole budget problem, but that appears unrealistic. The Report assumes, for example, a continuing 10 percent rate of inflation, and many of the proposed savings could be made effective only over a long period of years. The proposed savings of $424 billion thus appear to be overstated and not realistic for the three years immediately ahead. Consequently, the Report, in our view, does not provide the full solution to our current deficit problem. What is needed is an immediate and fundamental reassessment of federal spending and revenue programs by the Congress and the Administration in order to achieve significant deficit reductions.

(6) While we recognize that the line item veto would impact on only a part of the federal budget, we support its adoption, as did the Grace Commission.

(7) Reducing the deficit is urgent and we support a large and immediate deficit reduction program, even if it means increasing the level of taxes.

(8) We support revision of the tax system that would attack the proliferation of tax shelters and the "underground economy."

Federal Reserve Policy

We support the Federal Reserve in its efforts to check inflation. We regard the range of money supply targets recently announced for 1984 as appropriate for the economy at this stage of the expansion. We do not support efforts that would restrict or narrow the operating targets of the Fed. There is a need for judgmental discretion in responding to unusual economic or financial developments.

As Chairman Volcker has pointed out, a substantial reduction in the deficit is needed to give the Federal Reserve more flexibility in pursuing the objectives of monetary policy.

Industrial Policy

The term "industrial policy" is applied to a wide range of proposals which are usually intended to encourage new high-technology industries or to help old industries which are in decline or adjusting to greater foreign competition. There are also proposals for some form of a "development bank" which would presumably aid businesses that cannot obtain adequate funds from private lenders.

We note that a common feature in these proposals is an attempt to substitute some central control or governmental judgment for the results of competitive markets. The nature and extent of subsidies involved are usually poorly defined. Moreover, such measures cannot take the place of sound fiscal and monetary policy. The Economic Report of the President has a chapter assessing the nature of "industrial policies," and we agree with their conclusion which runs in part as follows:

> "...As we look to the future, it is important to raise the Nation's rate of saving by reducing the government budget deficits. We must also seek new ways to revise the tax laws in order to reduce the disincentives that still restrict the rate of capital formation.
>
> "Our market economy and its system of rewards for superior performance have made the American economy the most productive and innovative in the world. An industrial policy that increases government planning, government subsidies and international protectionism would only be a burden on our economic life and a threat to our long-term economic prosperity." (page 111)

International Trade, Debt Problems, and the Exchange Value of the Dollar

The federal deficit is one of the factors contributing to the high level of interest rates in the United States. (See pages 37-40 of the Economic Report of the President.) These high rates, as well as the safe haven provided by this country, are major reasons for the large inflows of foreign funds, which have financed a substantial part of the federal deficit.

But the inflows of foreign funds to this country have contributed to an overvaluation of the dollar, recently estimated to amount to 32 percent by the Council of Economic Advisers. A high value of the dollar encourages imports and discourages exports. The result has been an unprecedented trade deficit which is projected to reach more than $100 billion in 1984. A trade deficit of this size reflects the heavy burdens placed by the high value of the dollar on our export industries and on businesses that compete with imports.

Overvaluation of the dollar also intensifies the debt problems of developing countries. These debts are generally denominated in dollars, so that an increase in the exchange value of the dollar increases the burden of interest payments and, at the same time, tends to reduce the export earnings of the debtor countries.

Benefits from a Large Deficit Reduction Program

A substantial program for reducing the federal budget deficit will have important benefits:

(1) Interest rates will be lowered since federal competition for funds in the capital markets will be reduced. To the extent that fiscal action dampens market expectations of future inflation, interest rates will be lowered still further by a reduction in the inflation premium.

(2) Reductions in interest rates will make private borrowing to foster capital formation less expensive. Increased capital formation will over time raise the rate of productivity and economic growth.

(3) Lower interest rates will reduce the incentive for foreign funds to flow into this country. In turn, this effect on the international flow of funds will tend to bring the exchange value of the dollar to more realistic levels, thus leading to better markets for our exports and reduced competition from imports. Lower interest rates will help to mitigate the debt problems of developing countries.

(4) Reductions in the deficit and in interest rates will reduce the burden of interest on the debt. Without serious action to reduce the deficit, interest costs will become a runaway item in the budget, swamping efforts at deficit reduction in other components of the budget.

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